United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

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76-7243

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In The

United States Court of Appeals

For The Second Circuit

No. 76-7243

Aubrey B. Lank,
As Receiver of
Pickard & Company, Incorporated
Plaintiff-Appellee,

—against—

The New York Stock Exchange,
Defendant-Appellant.

On Appeal from the United States District Court For the Southern District of New York

BRIEF FOR DEFENDANT—APPELLANT

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Statement of the Issues

The issues certified for immediate appeal pursuant to 28 U.S.C. § 1292(b) are:

(1) Whether the receiver of a former member corporation of the New York Stock Exchange, Inc. (the "Exchange"), a national securities exchange, has standing (or alternatively "capacity") to assert a claim against the Exchange under Section 6 of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78f, on behalf of the member corporation, and

(2) Whether a three year or six year statute of limitations is applicable to a claim under Section 6. (JA-248a)*

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* References are to pages of the Joint Appendix.

Statement of the Case

The Exchange appeals pursuant to 28 U.S.C. § 1292(b) from an order of the United States District Court for the Southern District of New York (Lasker, J.), 405 F.Supp. 1031 (S.D.N.Y. 1975), denying in part and granting in part the Exchange's motion to dismiss and for summary judgment. (JA-215a)

The plaintiff-appellee ("Lank") is the receiver of Pickard & Company, Incorporated ("Pickard"), which had been a member corporation of the Exchange prior to its liquidation in the spring of 1968. (JA-7a, 31a) The Exchange is a national securities exchange registered with the Securities and Exchange Commission (the "Commission") pursuant to Section 6 of the Exchange Act and is composed of individual members engaged in the securities business, the majority of whom are associated with organizations (either partnerships or corporations, referred to as "member organizations") engaged in the securities business. (JA-27a)

Lank commenced this action in December 1971 (JA-4a), more than 2½ years after his appointment as receiver (JA-89a), more than 3 years after Pickard ceased doing a securities business (JA-7a), and more than 5 years after the events complained of. (JA-6a) The complaint asserts four claims against the Exchange. (JA-6a) The first claim is based on Section 6 of the Exchange Act and alleges that the Exchange failed to enforce the Exchange Act and its own rules by failing to put Pickard out of business in October 1966; the second claim is based on common law fraud and alleges that the Exchange's failure to suspend Pickard in October 1966 constituted a fraudulent representation that Pickard was a responsible Exchange member; the third claim alleges that the Exchange was grossly negligent; and the fourth claim asserts that an implied contract between Pickard and the Exchange was allegedly breached by the Exchange's purported failure to enforce the Exchange Act and its own rules.

The Exchange answered the complaint, denying the substantive allegations, setting up affirmative defenses and asserting three counterclaims. (JA-16a) The first and second counterclaims are based on agreements entered into by Pickard to secure the assistance of the Exchange and the Special Trust Fund of the Exchange to put Pickard's books and records in order and to protect Pickard's customers against loss of their money or securities as a result of Pickard's chaotic condition. (JA-47a, 49a) In the course of the subsequent liquidation of Pickard, the Exchange recovered $269,648 due from Pickard under the agreements. (JA-40a, 41a) At the time of the assertion of the counterclaims, $56,712.09 remained due to the Exchange, and $170,295.42 was due to the Special Trust Fund of the Exchange, which assigned its claim to the Exchange. (JA-29a) The third counterclaim was asserted by the Exchange as a creditor of Pickard against the receiver personally for waste of corporate assets in his pursuit of this patently unmeritorious action and for the receiver's attempt to use this action to force settlement of the Exchange's creditor claims by the threat of lengthy and costly litigation.

In April 1975, the Exchange moved (1) to dismiss the complaint for failure to prosecute; (2) for summary judgment on the ground that plaintiff lacked capacity to assert the alleged claims; (3) for summary judgment on the ground that the only federal claim, the first, was barred by the applicable statute of limitations, and the court was thus without jurisdiction of the allegedly pendent claims; and (4) for summary judgment on its three counterclaims. (JA-26a) The court below granted, on the ground of lack of capacity, the Exchange's motion to dismiss claims asserted by Lank on behalf of Pickard's customers, creditors, subordinated lenders and shareholders; granted summary judgment as to liability on the Exchange's first and second counterclaims; and denied the motion in all other respects, thus sustaining Lank's standing to assert claims under Section 6 on behalf of Pickard and applying the six year contract period of limitations of N.Y. CPLR § 213(2) to the

Section 6 claim. (JA-215a) The Exchange sought and was granted a modification of the Court's decision and order pursuant to 28 U.S.C. § 1292(b) adding the Court's certification for immediate appeal. (JA-245a, 247a) This Court granted the Exchange's petition for permission to appeal on May 25, 1976.

Statement of Facts

Until early 1968 Pickard engaged in a general securities business. (JA-7a) The rules of the Exchange in effect in 1967 required that each member organization have a surprise audit conducted at least once each calendar year by independent certified public accountants retained by the member organization. (JA-32a) On September 29, 1967 Haskins & Sells commenced such an audit of Pickard. (JA-33a) In January 1968 Haskins & Sells reported to the Exchange that it would be unable to complete the audit due to deficiencies and inaccuracies in Pickard's books and records. (JA-33a) The Exchange immediately sent its examiners to Pickard. They confirmed that Pickard's books and records did not permit compilation of accurate financial statements. (JA-33a) On February 9, 1968, the Exchange ordered Pickard to restrict its business with customers and on February 13 to cease doing a general securities business. Pickard agreed. (JA-33a) On February 13 Pickard also entered into an agreement with the Exchange by which Pickard obtained the assistance of Exchange employees in putting its books and records in order. (JA-46a) During the course of this work, it became apparent that Pickard lacked sufficient liquid assets to pay to its customers their credit balances of cash and securities. (JA-35a) In order to prevent the imminent loss of these customer's securities, Pickard entered into a further agreement with the Exchange on or about May 16, 1968 (the "May Agreement"), which provided that the Special Trust Fund* of the Exchange might make funds

* The Special Trust Fund was established pursuant to Article XIX of the Exchange Constitution. Sec. 1 of Article XIX is reproduced in the addendum at p. A-50.

available for assistance to customers of Pickard, and Pickard agreed to the Exchange's appointment of a liquidator upon the first use of such funds. (JA-49a) Such funds were provided on May 21, 1968, and a liquidator, Lloyd W. McChesney, was appointed. (JA-37a) Mr. McChesney put the books and records of Pickard into the best practicable order, paid off all customers and substantially all general creditors (with the notable exception of the Exchange), and asserted all claims of Pickard promising significant recovery. (JA-39a, 43a, 44a) He pursued these tasks to the fullest extent feasible until March 21, 1969, when the Exchange as a creditor of Pickard petitioned the Court of Chancery of the State of Delaware (Pickard's state of incorporation) for the appointment of a receiver for Pickard. Pursuant to the Exchange's petition, Lank was appointed receiver of Pickard on April 22, 1969. (JA-89a) On December 17, 1971, Lank commenced this action. (JA-4a)

ARGUMENT

I

The receiver of a former member corporation of the Exchange lacks standing to assert a claim against the Exchange under Section 6 of the Exchange Act.

The court below erred in sustaining Lank's capacity to assert on behalf of Pickard an implied right of action under Section 6. In reaching its conclusion, the court below misconstrued the terms of the statute and its history, the effect of the case law and important policy considerations.

A. Under state law the receiver has standing to assert only those claims which the corporation could have asserted.

The court below dismissed for lack of standing the claims of Lank insofar as they were based on alleged damages to Pickard's customers, creditors, subordinated lenders and stockholders. (JA-224a) However, looking to the prayer for relief, it found the complaint asserted claims directly on behalf of Pickard as well. (JA-225a) Although the Ex-

change does not agree with that finding, it is the Exchange's position on this appeal that, if such claims were pleaded, the receiver cannot assert them because the corporation itself lacks standing under the statute to assert a Section 6 claim. *See infra* Point IB.

The court below noted the general rule that a receiver is subject to the same defenses as the corporation he represents, but held that a receiver has power to sue in certain situations where the corporation would not. (JA-228a) The court based that holding on *Bovay* v. *H. M. Byllesby & Co.*, 26 Del.Ch. 69, 22 A.2d 138 (1941), *Keedy* v. *Sterling Electrical Appliance Co.*, 13 Del.Ch. 66, 115 A. 359 (1921) and 16 Fletcher, *Cyclopedia of Corporations*, § 7813 (1962 rev. ed.). Those authorities are inapposite. *Bovay* and *Keedy* were actions to recover funds from the recipients, and participants in, fraudulent transfers. The reference to Fletcher is to the same effect. Furthermore, both *Bovay* and *Keedy* involved schemes by the officers of the insolvent corporation to create a second corporation for the purpose of receiving assets to be fraudulently transferred from the insolvent corporation. Lank has made no claim against the Exchange for fraudulent transfer.

The Delaware statute, pursuant to which Lank was appointed, limits a receiver's powers as follows:

> "Whenever a corporation shall be insolvent, the Court of Chancery . . . may . . . appoint one or more persons to be receivers . . . to take charge of its assets . . . to prosecute and defend . . . all claims or suits . . . and to do all other acts which might be done *by the corporation* . . .". (8 Del. Code Ann. § 291 (1975)) (emphasis added)

The Delaware cases strictly construe this limitation. In *Asmussen* v. *Quaker City Corp.*, 18 Del.Ch. 28, 156 A. 180 (1931), the court dismissed a creditor's bill of complaint praying for appointment of a receiver because the corporation while insolvent had given preferences to certain creditors. The court stated that since the corporation itself

could not sue to recover the assets transferred, neither could a receiver, and thus his appointment would be of no avail.

The same statutory limitation was given effect in *Delaware Trust Co.* v. *Elder & Co.,* 12 Del.Ch. 362, 112 A. 370 (Del. 1920). In *Delaware Trust* the receiver could not set up a defense against conditional vendors who alleged noncompliance with the Uniform Conditional Sales Act and who claimed an equitable lien on the corporate assets. The court said:

> "What rights, then, has the receiver acquired respecting the property as against the vendors? The receiver acquired none as representing either the buyer or its creditors, for none of them had any rights as against the vendors." (112 A. at 370)

See also In re Frederica Water, Light & Power Co., 10 Del.Ch. 362, 93 A. 376 (1915).

Reliance by the court below on *Pettit* v. *American Stock Exchange,* 217 F.Supp. 21 (S.D.N.Y. 1963), *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 410 F.2d 135 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969) and *Seligson* v. *New York Produce Exchange,* 378 F.Supp. 1076 (S.D.N.Y. 1974), *appeal docketed sub nom. Miller* v. *New York Produce Exchange,* No. 75-5024 (2d Cir. February 2, 1976), was misplaced. Each of those cases involved the powers of a trustee in bankruptcy under federal law.

As the court below noted, although the roles of a trustee in bankruptcy and an insolvency receiver may be similar (405 F.Supp. at 1038 n.11, JA-215a), their powers and source of authority are different and they do not have equal standing to bring suit. Accordingly, it does not follow that simply because a trustee in bankruptcy has standing, an insolvency receiver has the same standing. The court below cited *Rockwood* v. *Foshay,* 66 F.2d 625, 630 (8th Cir. 1933), for the proposition that a receiver lacks standing to pros-

ecute creditors' claims (405 F.Supp. at 1035, JA-223a). In *Rockwood,* the court recognized, in terms which render any analogy to a trustee in bankruptcy inapposite, the limitations on a receiver's standing to sue. Cases allowing a trustee in bankruptcy to sue where the corporation may not have sued are based on the specific statutory powers given to a trustee under the Bankruptcy Act (11 U.S.C. § 1 *et seq.* (1970)). Those powers confer the status of an ideal creditor. *See* 4A Collier, *Bankruptcy* ¶ 70.49 at 595-96 (14th ed. 1976) (reference to §70(c), the so-called "strong arm clause"). By reason of such status bankruptcy trustees stand not only in the shoes of the bankrupt but also "in the overshoes of the creditors." *Schneider* v. *O'Neal,* 243 F.2d 914, 918 (8th Cir. 1957); 4A Collier, *Bankruptcy* ¶ 70.04, at 55-59 (14th ed. 1976).

Indeed, in marked contrast to a receiver under Delaware law, *Delaware Trust Co.* v. *Elder & Co., supra,* the trustee of a bankrupt vendee may prevail wherever a creditor, hypothetical or actual, would. Bankruptcy Act § 70(c) (11 U.S.C. § 110(c)); *Virshup* v. *Industrial Bank of Commerce,* 272 F.2d 43, 45 (2d Cir. 1959); *First Nat'l Bank* v. *Phillips,* 261 F.2d 588 (5th Cir. 1958); *Earhart* v. *Callan,* 221 F.2d 160 (9th Cir.), *cert. denied,* 350 U.S. 829 (1955); *Maguire* v. *Gorbaty Bros.,* 133 F.2d 675 (2d Cir. 1943); 4A Collier, *Bankruptcy* ¶ 70.57, at 660-61 (14th ed. 1976).

There is, thus, no basis in state or federal law for permitting Lank to assert a Section 6 claim against the Exchange where Pickard could not do so.

B. A member corporation of the Exchange is not among the intended beneficiaries of Section 6 of the Exchange Act and thus lacks standing to assert such a claim.

1. Standing to Assert a Statutory Violation Generally.

The question of standing to assert an implied cause of action for breach of statutory duty is virtually identical to the question of on whose behalf a private cause of action should be implied. That question was recently considered

by the Supreme Court in *Cort* v. *Ash,* 422 U.S. 66 (1975). There, the Court held four factors to be relevant to a consideration of when to imply a private cause of action. The first factor enunciated was, at 78: "[I]s the plaintiff 'one of the class for whose *especial* benefit the statute was enacted' ". *Cort* found (at 81-82) that if the plaintiff is not within the class for whose *especial* benefit the statute was enacted, he has no cause of action. As shown below, Lank fails to qualify under this standard, and he therefore lacks standing to pursue this action.

2. Section 6 is Designed to Protect Investors.

Section 6 of the Exchange Act, 15 U.S.C. § 78f, does not provide any private right of action. The statute requires the registration of national securities exchanges and, as in effect at the relevant time, provided in part*:

> "Registration of National Securities Exchanges
>
> "Sec. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:
>
> > "(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) *to comply, and to enforce so far as is within its powers compliance by its members,* with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;
> >
> > "(2) Such data as to its organization, rules or procedure, and membership, and *such other in-*

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* The two texts of Section 6 as enacted and in effect at all relevant times and as amended by the Securities Reform Act of 1975 are reproduced in the addendum at pp. A-1 and A-2.

formation as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

* * *

"(b) *No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation* of any provisions of this chapter or any rule or regulation thereunder *shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.*

* * *

"(d) *if it appears to the Commission* that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and *that the rules of the exchange are just and adequate to insure fair dealing and to protect investors,* the Commission shall cause such exchange to be registered as a national securities exchange.

* * *

"(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary *for the protection of investors,* withdraw its registration." (emphasis added).

The stated object of Section 6 is to maintain just and equitable principles of trade in order to protect investors. The only specified class of beneficiaries of Section 6 is investors.*

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* Section 19, 15 U.S.C. § 78s, which grants to the Commission powers with respect to exchanges additional to the powers granted in Section 6, also limits the class of beneficiaries to investors. Section 19 as enacted and in effect at all relevant times is reproduced in the addendum at p. A-9.

Under *Cort* v. *Ash, supra,* a cause of action may be implied only on behalf of that class.

3. The Legislative History Confirms that Section 6 was Intended to Benefit Public Customers Only.

The legislative intent as to the protected class is reflected in the Exchange Act's statement of its purpose:

> "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto. . . ." (Sec. 2, 15 U.S.C. § 78b)

The stated purpose of the legislation with respect to exchanges is to protect the customers who transact business through brokers on these exchanges. Nowhere is there evidenced any purpose to protect the brokers.

One of the major concerns of Congress leading to the enactment of the Exchange Act was fraud and manipulation in the public trading of corporate securities. As stated in the Senate Report:

> "The three principal problems with which the bill deals are the excessive use of credit for speculation, the unfair practices employed in speculation, and the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities." (S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934))

With respect to the regulation of exchanges, the congressional concern related to the control of trading on exchanges as markets and to the inadequacy of self-regulation. The Senate Report noted:

> "3. Inadequacy of Self-Regulation of Exchanges
>
> Stock exchanges have hitherto resisted proposals for their regulation by any governmental agency, on

> the ground that they are sufficiently able to regulate themselves *to afford protection to investors.* Especially during periods of popular agitation, or when legislative action has been threatened, the exchanges have taken steps to raise the standards for the conduct of business by their members and to require corporations to furnish more adequate information *for the benefit of investors.* Such attempts, however, far from precluding the necessity for legislative action, emphasize its need." (S. Rep. No. 792, 73d Cong., 2d Sess. 4 (1934)) (emphasis added)

The Report reflects the concern of the Senate with public trading of shares of stock of corporations listed on exchanges. The Report clearly distinguishes two areas of concern: (1) the conduct of members of exchanges and (2) the conduct of corporations whose shares are traded on exchanges. Both areas were of interest insofar as they affected customers' public trading in corporate securities. The object was to protect customers against misconduct by members of exchanges or by corporations whose shares are traded on exchanges.

The concern was similar in the House. The House Report, in its introductory paragraph, indicates that the purpose of the legislation is:

> ". . . to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes. . . ." (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 1 (1934))

The House Report stated the general purpose of the Exchange Act as follows:

> "[T]o regulate the stock exchanges and the relationships of the *investing public* to corporations which invite *public investment* by listing on such exchanges." (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 2 (1934)) (emphasis added)

The House Report reveals concern with regulating the exchanges as markets where the public customer trades in listed corporate securities. The following excerpts are representative:

> "The bill . . . is simply an earnest attempt to make belated intelligent adjustments, long required by changing conditions, in a faulty system of *distributing shares* in corporate enterprise *among the public*. . . . (*Id.* at 3)
>
> * * *
>
> "Since the war *the interest of the public at large in the ownership of corporate enterprise* has grown bigger, the size of the corporate unit has increased, the diffusion of corporate ownership has widened, all correlatively. (*Id.* at 3)
>
> * * *
>
> ". . . significant growth in size and importance of the exchanges and the *business they do with the public* . . . . (*Id.* at 4)
>
> * * *
>
> "As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and *protect that ordinary citizen's dependent position.* (*Id.* at 5)
>
> * * *
>
> "*The bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon,* and are not private clubs to be conducted only in accordance with the interests of their members." (*Id.* at 15) (emphasis added)

Congress wanted to insure that brokers and dealers, the professional traders, and the corporations whose shares

they traded, dealt honestly and fairly with the public customers. Congress was not concerned with providing any protection to the brokers and dealers themselves.

In addition to the broad conce[illegible] Congress had with the regulation of trading in corporate securities on exchanges for the protection of public customers, there were a number of specific concerns which led to enactment of the Exchange Act. One of these related to manipulations of the securities markets by the brokers and dealers using the facilities of an exchange, sometimes in concert with others, through pooling arrangements. The antagonistic interests of customers and brokers were nowhere more evident. The Senate Banking Committee reported that these pooling arrangements affected the prices of securities to the benefit of exchange members and other pool participants and to the detriment of public investors:

> "Both (a broker's) personal interest and his [illegible]bligation to the other participants (in the pool) inevitably clash with the duty of unswerving loyalty and ungrudging disclosure which he owes to his *customers*. However honest his intentions, an interest in a pool prompts him to encourage his *customers* to purchase the securities which are the subject of the pool operations. It is difficult to perceive how he could act disinterestedly on behalf of a *customer* if such action would be inimical to the welfare of the pool. The conclusion is inescapable that members of the organized exchanges who had a participation in or managed pools, while simultaneously acting as brokers for the *general public,* were representing irreconcilable interests and attempting to discharge conflicting functions." (*Senate Comm. on Banking and Currency, Report on Stock Exchange Practices,* S. Rep. No. 1455, 73d Cong., 2d Sess. 36 (1934)) (emphasis added)

The concerns of the Senate Committee on Banking and Currency were similar to those of the other congressional

committees considering the legislation. The general public as investors (customers of exchange members) was the class which the Congress wished to protect from improper activities of exchange brokers and dealers. Congress distinguished between these two groups and enacted legislation to protect one (the public investors) from the other (the brokers). These concerns and distinctions were expressed by Senator Fletcher when he introduced the bill in the Senate:

> "The bill just introduced for the regulation of securities exchanges is one of the series of steps taken and to be taken for the purpose of bringing safety to *the general public in the field of investment and finance.* The present step is made necessary by the misfortunes of great numbers of our people who have lost part, or all, of their savings through unregulated stock exchanges. . . .
>
> "It is in the light of the *interests of the general public* that the bill was drawn. There was no desire to hurt the few hundred men who have been obtaining, year after year, princely incomes out of the pockets of the American people through the operation of exchanges not subject to Government regulations. But while there was no desire to hurt these few men, the bill was drafted on the theory that the *interests of the general public* are paramount and that an end must be put to any mulcting of the general public for the benefit of a *few insiders.* The consequence of this legislation is likely to be that the *insider* who has relied upon his ability to take advantage of the unprivileged outsider will suffer; but this is unavoidable if the American people as a whole are to be protected from such persons. . . .
>
> * * *
>
> ". . . Although the bill does not prohibit all speculative activities on stock exchanges, its purpose is to make stock exchanges *market places for investors* and

not places of resort for those who would speculate or gamble.

"The purpose of the bill is to insure to the public that the securities exchanges will be fair and open markets. The bill seeks to protect the American people by requiring *brokers on these exchanges, members of these exchanges,* to be wholly disinterested in performing their services *for their clients and for the American people trading on the exchanges.*

". . . Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a *handful of men* to operate with stacked cards against the *general body of the outside investors.*" (78 Cong. Rec. 2270-71 (1934)) (emphasis added)

These congressional concerns led to the regulation of exchanges embodied in Sections 6 and 19 of the Exchange Act "for the protection of investors," *i.e.,* those members of the public who trade through members of exchanges in order to invest in corporate securities. Congress was not concerned with protecting the very organizations of brokers, such as Pickard, which were the constituent members of the exchange.

The importance of looking to congressional intent to determine the parameters of implied causes of action has recently been emphasized by the Supreme Court in *Ernst & Ernst* v. *Hochfelder,* 96 S.Ct. 1375 (March 30, 1976); *Cort* v. *Ash, supra; Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975); and *Securities Investor Protection Corp.* v. *Barbour,* 421 U.S. 412 (1975). That *Cort* v. *Ash, supra,* had not been decided at the time of the motion below may have contributed to the court's misinterpretation of the parameters of a Section 6 action, which are evident from a reading of the legislative history. That

history reveals that public investors are the only members of the class for whose especial benefit the statute was passed.

This reading of the legislative intent is borne out by the recent enactment of the Securities Investor Protection Act ("SIPA"), 15 U.S.C. § 78aaa. In SIPA, Congress had occasion for the first time to define the term "customer" or "investor" in the context of exchange member organizations. SIPA was enacted in 1970 as a result of the failure of numerous broker-dealers, such as Pickard. The failures of these broker-dealers caused losses not only to the customers but to the brokerage community as well. Nevertheless, the protection of Section 6 of SIPA was extended only to "customers", which:

> ". . . shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor. . . ." (15 U.S.C. § 78fff(c)(2)(A)(ii))

Although SIPA itself speaks of "customers", the House Report on SIPA evidenced concern for "investors":

> "The primary purpose of the reported bill is to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles.
>
> * * *
>
> "While the totality of the rules and regulations noted above provide important protections for investors, it is clear that these rules are not sufficient by themselves to prevent the exposure of customers to substantial risk of loss. . . ." (H.R. Rep. No. 1613, 91st Cong., 2d Sess. 1, 3 (1970))

This Court recently dealt with the SIPA definition of customer in *Securities Investor Protection Corp. v. Morgan, Kennedy & Co., Inc.*, 533 F.2d 1314, at 1317 (2d Cir.), *cert. denied*, 44 U.S.L.W. 3719 (June 15, 1976), and noted

that "the essential criterion for establishing 'customer' status" was that the individual be "a public investor." The definition was also considered by this Court in S.E.C. v. *F.O. Baroff Company, Inc.*, 497 F.2d 280, at 283 (2d Cir. 1974), where it noted that in the House Report on SIPA: "'investors' is used synonymously with 'customers.'" The broker-dealer itself (Pickard) surely is in no position to recover as a customer or to be included within the benefited class of investors.

The provisions of SIPA are more than persuasive in determining the class that Congress believes is in need of protection under the securities laws and thus what "investor" means under the Exchange Act. The provisions of SIPA expressly amend the Exchange Act:

> "Except as otherwise provided in this (Act), the provisions of the Securities Exchange Act of 1934 (hereinafter referred to as the '1934 Act') apply as if this (Act) constituted an amendment to, and was included as a section of, such Act." (15 U.S.C. §78bbb (1970))

Thus, the definition of customer, and its identity with the term investor, as used in SIPA and as part of the Exchange Act itself, is decisive as to the class Congress intended to protect.

That the protection of Section 6 of the Exchange Act runs to the public customer of the member, and not to the member organization, is further supported by recent Commission regulations. The rules of the Commission promulgated pursuant to Section 15(c) of the Exchange Act relating to the financial responsibility of broker-dealers in over-the-counter markets specifically define those who are in need of protection as "customers" and define that term as follows:

> "(1) The term 'customer' shall mean any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities

for the account of such person, but shall not include a broker or dealer, or a general, special or limited partner or director or officer of a broker or dealer, or any person to the extent that such person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer. . . ." (17 C.F.R. § 240.15c3-3(a) (1975))

Thus, in one of the specific areas in which Pickard was allegedly in violation of Exchange rules, financial responsibility, the Commission considers only customers to be entitled to the statutory protections.

4. Decisions in Private Actions Brought Against an Exchange for Breach of its Statutory Duty Under Section 6 Show that the Action Lies on Behalf of Public Customers Only.

The first case implying a private right of action under Section 6 was *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944). *Baird* arose from the conversion of customers' securities by a member of the Exchange. The Exchange had been put on notice of the conversion and had taken no action. This Court found a right of action on behalf of the customers but directed judgment for the Exchange because there had been no proof that the Exchange's breach of duty had caused the plaintiffs' damage. Judge Clark, who dissented on the issue of causation, gave careful analysis to the legislative purpose and said:

"[T]he Act was enacted for the benefit and protection of customers of members of registered exchanges and of such members of the general public, including plaintiffs, as might carry on security transactions with members of a registered exchange . . ." (141 F.2d at 242)

and:

"One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public." (*Id.* at 244)

Baird confirms the Exchange's position that Section 6 was enacted for the especial benefit of public customers of exchange members.

There have been a number of subsequent cases against exchanges which have discussed the duty that may be enforced in a private action under Section 6. The vast bulk of such cases was brought by customers. *E.g., Butterman* v. *Walston & Co., Inc.,* 387 F.2d 822 (7th Cir. 1967), *cert. denied,* 391 U.S. 913 (1968); *Rich* v. *New York Stock Exchange,* 379 F.Supp. 1122 (S.D.N.Y. 1974), *rev'd on other grounds and remanded,* 522 F.2d 153 (2d Cir. 1975); *Schonholtz* v. *American Stock Exchange, Inc.,* 376 F.Supp. 1089 (S.D.N.Y. 1974), *aff'd,* 505 F.2d 699 (2d Cir. 1974); *Marbury Management, Inc.* v. *Kohn, Wood, Walker & Co.,* 373 F.Supp. 140 (S.D.N.Y. 1974); *Steinberg* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* [1973-74 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 94,599 (S.D.N.Y. 1974); *Hochfelder* v. *Midwest Stock Exchange,* 350 F.Supp. 1122 (N.D. Ill. 1972), *aff'd,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974). Standing was not at issue in these cases.

One case which did focus specifically on the question of standing to assert a Section 6 private action was *Caddell* v. *Goodbody & Co.,* [1973 Transfer Binder] CCH Fed.Sec.L. Rep. ¶ 93,938 (N.D.Ala. 1972). *Caddell* was an action against a brokerage firm, the firm's accountants and the Exchange. The plaintiffs in *Caddell* were the owners of three corporations who had sold their interests in the corporations in return for stock of the buyer. The action was based on fraud in connection with the transaction on the part of a partner of the brokerage firm. Plaintiffs alleged that the Exchange had permitted its member firm to operate in violation of net capital requirements and had concealed the firm's financial position. The court recognized the private right of action under Section 6 but found the plaintiffs without standing to assert that right, stating:

> "In summary, it appears that a national exchange owes a statutory or contractual duty to reasonably

> supervise its members to prevent damage to customers. If the New York Exchange had knowingly allowed Goodbody & Co. to violate exchange rules adopted in part for the protection of customers, a customer of Goodbody who could trace his losses to the exchange's failure to act might have a cause of action against the exchange. The Caddells were not customers of Goodbody, and this court finds that the duty of the exchange does not run to the benefit of the plaintiffs in the posture of the Caddells." (*Id.* at 93,739)

Only a few cases have involved more than the complaint of a member broker's customer against a broker alleging that the exchange failed properly to supervise its member broker. Among those few cases, only *New York Stock Exchange, Inc.* v. *Sloan,* 394 F.Supp. 1303 (S.D.N.Y. 1975), another decision by Judge Lasker, contains an independent analysis of the standing question.* The cases decided subsequent to *Sloan* simply follow the *Sloan,* or *Lank,* analyses.

Sloan was an action by the Exchange and the Trustees of the Exchange's Special Trust Fund to recover money expended to safeguard the interests of the public customers of Orvis Brothers & Co., a member organization of the Exchange. Certain defendants in *Sloan,* general partners, limited partners and subordinated lenders of Orvis, asserted counterclaims against the Exchange based on Section 6 of the Exchange Act. The Exchange moved to dismiss these counterclaims for lack of standing. The court granted the motion as to defendants who were general partners and denied the motion as to other defendants. The decision to dismiss the counterclaims of general partners was based on the court's finding that the Exchange rules at issue in *Sloan,* which are the same rules at issue here, were designed to govern the conduct of the general partners and

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* The Exchange's petition for § 1292(b) certification in *Sloan* was denied on the ground that, because there were many other issues and parties, immediate appeal would not advance ultimate termination of the action.

not designed to protect those partners. (394 F.Supp. at 1311) The court noted, at 1311:

> "The Exchange cannot have failed to enforce the rules unless the general partners failed in the first instance to comply with them. . . ."

Indeed, in *Sloan,* the court agreed with the Exchange's argument:

> "[T]hat it would mock the statutory scheme to 'allow a member who is part of the entity charged with the duty of enforcement to assert a violation of that duty.' " (394 F.Supp. at 1312)

It can be seen that under the rationale of *Sloan,* the receiver's claim must fail, particularly since *Sloan* was decided prior to the Supreme Court's decision in *Cort* v. *Ash, supra,* that the plaintiff must be one for whose "*especial*" benefit the statute was enacted. Applying that requirement to *Sloan* would have defeated all the counterclaims and defeats Lank's claim here. As the *Sloan* court noted, the "primary" purpose of the Exchange Act was the protection of public customers. (394 F.Supp. at 1308) Inasmuch as the interests of public customers are oftentimes antagonistic to those of Exchange members, it cannot be said that Section 6 was enacted for the especial benefit of both groups. As is evident from the review of the legislative history above, Congress sought to protect the public customer from the brokers who were exchange members. (*See* pp. 11-19, *supra*). The Exchange contends that the decisions below and in *Sloan* were in error by permitting suit by other than public customers.

The order of the court below may be sustained only by finding that the member organizations of the Exchange are the group for whose especial benefit Section 6 was enacted. The court below made no such finding. Nor did any of the cases relied upon. Most of the cases were decided before *Cort* v. *Ash, supra,* and do not conform to its holding. Indeed, the numerous lower court cases have quite naturally

built upon each other, creating a body of law on standing which has not been subjected to appellate scrutiny and is inconsistent with the Supreme Court's recent teachings. Those cases include *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 410 F.2d 135 (7th Cir.), *cert.denied,* 396 U.S. 838 (1969); *Seligson* v. *New York Produce Exchange,* 378 F.Supp. 1076 (S.D.N.Y. 1974), *appeal docketed, sub nom. Miller* v. *New York Produce Exchange,* No. 75-5024 (2d Cir. February 2, 1976); *Pettit* v. *American Stock Exchange,* 217 F.Supp. 21 (S.D.N.Y. 1963); *Hughes* v. *Dempsey-Tegeler & Co.,* [1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 94,133 (C.D. Cal. 1973), *aff'd,* 534 F.2d 156 (9th Cir. 1976); *Weinberger* v. *New York Stock Exchange,* 335 F.Supp. 139 (S.D.N.Y. 1971); *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange,* 327 F.Supp. 495 (E.D. Pa. 1971).

Pettit v. *American Stock Exchange, supra,* was an action by corporate reorganization trustees, appointed pursuant to Chapter X of the Bankruptcy Act, alleging a conspiracy resulting in a fraudulent distribution of stock of the corporation in violation of Section 10 of the Exchange Act and the rules thereunder. While recognizing the general proposition that an exchange's duties run to the investing public only, the court permitted the action to continue against the exchange because of the exchange's alleged actual participation in the conspiracy. Not only is *Pettit* entirely different from this case in that the thrust of the *Pettit* allegations was not, as here, that the exchange failed to supervise its member, but furthermore *Pettit* did not have the benefit of the *Cort* v. *Ash* guidelines.

As Judge Lasker noted, the decision in *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, supra,* is "not directly applicable" to this case. (405 F.Supp. at 1038, JA-230a)

Seligson v. *New York Produce Exchange, supra,* a case arising out of the "salad oil swindle", is equally inapposite. *Seligson* was brought by the trustee in bankruptcy of Ira Haupt & Co., a commodities broker against, *inter alia,* a commodities exchange. Although commodities ex-

changes are not wholly dissimilar from securities exchanges, they are established pursuant to a different act with different legislative history, and their duties are prescribed by that act. Commodity Exchange Act, 7 U.S.C. §§ 1 *et seq.* Unlike the Exchange Act, that act imposes a specific obligation on commodities exchanges to maintain an orderly market. (7 U.S.C. § 7(d)) Moreover, the legislative history evidences a concern for the welfare of those in the plaintiff's position. Furthermore, the *Seligson* court noted:

> ". . . [T]he doctrine of *in pari delicto* must give way, at least insofar as defendants are charged with intentional failure to maintain the market. A different rule may be appropriate where plaintiff has acted wantonly and wilfully, and where defendant merely has been negligent. . . ." (378 F.Supp. at 1086)

That different rule is clearly appropriate here. Although the court below, likening its decision to that in *Seligson,* said (405 F.Supp. at 1039, JA-231a): ". . . the ultimate beneficiaries of any recovery by Lank are third parties who share no culpability for Pickard's wrongdoing and ultimate demise," it had no basis in the record for doing so. In fact, all of the voting stockholders of Pickard, who may share in a distribution of the estate, were officers of Pickard, were charged by the Exchange for their activities at Pickard (JA-165a), were found responsible for the wrongdoing, and were disciplined.

In *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange, supra,* the plaintiff was a member of the exchange who alleged he had been improperly excluded from the exchange's board. *Bright* proceeds on the theory that due to the nature of exchanges, they may be required to enforce their rules with equity and fairness. *See Silver* v. *New York Stock Exchange,* 373 U.S. 341, 361 (1963). *Bright* has no relevance to the claim made here, and, in any event, preceded *Cort* v. *Ash* and thus did not consider its requirements.

The plaintiff in *Hughes* v. *Dempsey-Tegeler & Co.*, *supra*, had been a customer who became a subordinated lender to that member organization. Decided prior to *Cort* v. *Ash*, the court found that plaintiff had pleaded a claim under Sections 12 and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77l, 77q, and under Sections 6 and 10 of the Exchange Act against the Exchange. With respect to the Section 6 claim, the district court said:

> "Accordingly, Hughes did have a private right of action against the Exchange for an alleged violation of its section 6 duties toward Dempsey under the Securities Exchange Act. The measure of this duty as applied to the facts of this case, i.e. whether the Exchange abused its discretion, or otherwise violated its statutory charge, depends to a certain extent upon Hughes' status, and, to a greater extent, upon the nature and amount of information to which Hughes had access—or to which he should have had access. These are questions which must be reserved for a simultaneous treatment of Hughes' relationship with the other principal characters, and of the evolution of the subordination agreement." ([1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 94,133 at 94,539-40)

Thus, the *Hughes* decision avoided a consideration of standing under Section 6. In affirming the dismissal of the action following trial, the Court of Appeals for the Ninth Circuit gave minimal treatment to the question of plaintiff's standing. In a footnote the court commented upon, but did not deal with the standing question, relying entirely on Judge Lasker's opinion in *Sloan*. (534 F.2d at 165 n.4) Indeed, the *Hughes* court's failure to focus on standing is further illustrated by its footnote 5, at 166, where it considered the implication of a private right of action under Section 6. The court's cursory treatment of *Cort* v. *Ash, supra,* and *Securities Investor Protection Corp.* v. *Barbour, supra,* indicates that it did not consider how the question of when to imply a private cause of action

relates to the question of on whose behalf a cause may be implied. The fact that a private cause of action may be implied on behalf of the class for whose especial benefit the statute was enacted, obviously does not mean that a cause of action is to be implied on behalf of any plaintiff who asserts such a claim. Neither Hughes nor Lank falls within the class protected by Section 6.

Weinberger v. *New York Stock Exchange, supra,* considered only whether the plaintiff's action was barred by the applicable statute of limitations. The court held that the plaintiff was the third-party beneficiary of the "agreement" between the Exchange and the Commission required by Section 6(a) of the Exchange Act because:

> "The agreement with the SEC by the Exchange 'was made for the benefit and protection of investors, of which plaintiff is one' (Amended Compl. P 14)." (335 F.Supp. at 142)

The court did not analyze plaintiff's standing. Instead, it relied on his allegation that he was an investor. In fact, the plaintiff in *Weinberger* had been a limited partner of the member organization.

Two recent decisions have followed Judge Lasker's decisions in *Sloan* and *Lank* without consideration of *Cort* v. *Ash, supra. Carr* v. *New York Stock Exchange,* [1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,563 (N.D.Cal. 1976); *Collins* v. *PBW Stock Exchange, Inc.,* 408 F.Supp. 1344 (E.D.Pa. 1976). In *Carr* the court observed:

> "Defendants contend that by § 6 Congress intended to protect only the public customers of the Exchange and not private investors in the brokerage houses themselves. This contention is not without merit. There were no such investors in 1934 because brokerage houses were not permitted to incorporate until 1953. In addition, in 1970 Congress specifically excluded investors in brokerage houses from the protection af-

> forded Exchange 'customers' in the Securities Investors Protection Act." ([1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,563 at 99,808)

However, the *Carr* court felt constrained by the decisions in *Hughes, Weinberger* and *Sloan* to find a congressional intent to protect "all parties likely to be harmed" (*id.* at 99,808), and thus to find the plaintiffs, who were employees and stockholders of a member organization, to have standing. However, there simply is no basis in the legislative history for finding such an unlimited congressional intent. Moreover, such an approach is contrary to the guidelines set out by the Supreme Court in *Ernst & Ernst* v. *Hochfelder, supra; Cort.* v. *Ash, supra;* and *Blue Chip Stamps* v. *Manor Drug Stores, supra.*

The *Collins* action was brought by the trustee of the estate of a member of the Philadelphia-Baltimore-Washington Stock Exchange, Inc. ("PBW") against PBW under Section 6 of the Exchange Act and Section 9(c) of SIPA, alleging PBW negligently failed to enforce its rules against the debtor-member and failed to prevent the debtor-member's violation of an order of PBW. The court properly enunciated the test for standing as "whether the party asserting a cause of action is within the class intended to be benefited . . .". (408 F.Supp. at 1348) The court, however, failed to judge the plaintiff's standing under this test, proceeding from its statement of the test to a consideration of the availability of the defense of estoppel. The *Collins* court's "progressive" approach to standing (408 F.Supp. at 1348) cannot be reconciled with *Cort* v. *Ash, supra.* Moreover, the assumption in *Collins* that a broader implied right will afford greater protection to the investing public (408 F. Supp. at 1346-47 n. 1 and 1348) is unfounded. Finding a duty to different parties, such as the investing public and the member organization, may very well not result in the greatest protection to the investor. (*See* Point IB6, *infra*) Nor will the net result be an added stimulus to compliance, as suggested by the *Collins* court. (*Id.* at 1347) If each

member organization feels it can look to the Exchange if it fails to comply, it will not be encouraged to attend to its own compliance.

The Exchange contends that *Sloan* (to the extent it found limited partners and subordinated lenders to have standing) was incorrectly decided. But even if *Sloan* and its progeny were rightly decided, they do not support the result reached below. In *Sloan,* the court differentiated those it found responsible for and empowered to effect a member organization's compliance with the Exchange Act and rules and regulations thereunder (partners of the member firm) from those who were not (limited partners and subordinated lenders). This same distinction supports the result in all cases where the plaintiff was not a customer, except the instant action and *Collins.* In *Sloan,* those responsible for the member organization's compliance (the partners) were held to lack standing to assert the Exchange's alleged breach of duty. Yet, here the court has found the member organization itself able to assert the Exchange's failure to prevent that member organization's very own transgressions. Thus, the object of the regulation, the entity charged with compliance, the entity responsible for its own compliance and for that of its officers, directors and employees may charge the Exchange with liability for the organization's very own failings. The member organization, a part of the entity charged with the duty of enforcement, would simply be accusing itself as a member of the aggregate body. The actual violator would recover against the other Exchange members who did not participate in the violation. Such a result would controvert the policies of the Exchange Act.

5. The Distinction Between the Exchange Member and the Public Customer has been Recognized in Analogous Circumstances.

Differentiating between the customer and the broker as a proper object of protection is supported by substantial

judicial precedent. Such a distinction has been made under the securities laws in analogous cases. In *Wilko* v. *Swan,* 346 U.S. 427 (1953), the Supreme Court held that a customer of a member organization could not be required to arbitrate claims against the organization, despite his agreement to do so, if those claims were based on alleged violations of the federal securities laws. The securities laws were enacted to protect such customers, and pursuant to Section 14 of the Securities Act of 1933 (15 U.S.C. § 77n), such claims cannot be waived. However, persons with the appropriate privity to the Exchange, such as partners of member firms and subordinated lenders to member firms, are not given the same protection.

In *Coenen* v. *R.W. Pressprich & Co., Inc.,* 453 F.2d 1209, at 1213 (2d Cir.), *cert. denied,* 406 U.S. 949 (1972), analyzing *Wilko,* this Court said:

> "Secondly, *Wilko* involved a dispute between an investor and a member of a national securities exchange, not a 'dispute between members.'
>
> * * *
>
> "[T]he policy considerations relied on by the Supreme Court in *Wilko* are inapposite here. The Supreme Court found that the non-waiver provision there involved was designed to *protect investors.* . . . Without such provision, financial houses might escape statutory liability by taking advantage of the inferior bargaining position of customers. But the legislative policy of protecting investors will not be thwarted by compelling an exchange member to arbitrate. . . .' " (emphasis added)

This Court differentiated an investor from a member and held only the investor entitled to the protections of the securities laws. Similarly, in *McDonnell & Co., Inc.,* v. *Cohig,* [1970-71 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 92,886, at 90,310 (Sup.Ct.N.Y. Co. 1970), the *Wilko* case was held inapplicable to preclude arbitration of the claimed

securities laws violations where plaintiffs were officers of a member firm:

> "... as officers of the member firm, the claimants need not be afforded the same protection as public customers of the firm."

Arbitration is not the only area where distinctions between customers and others have been recognized. In the context of a bankruptcy of a member organization, customers are given special priorities to recover their assets even before general creditors. Bankruptcy Act § 60e (11 U.S.C. § 96(e))

6. Policy Considerations Require Limiting to Public Customers the Implied Private Right of Action Against the Exchange Under Section 6.

The very nature of an exchange compels distinguishing the public customer from the member of the exchange community (or investor in the member) and limiting the Section 6 implied private right of action to the customer. Prior to enactment of the federal securities laws, exchanges were regarded by Congress and the public as private clubs. *See e.g.,* S. Rep. No. 1455, 73d Cong., 2d Sess. (1934). The Exchange itself was:

> "[A] voluntary association of individuals, united, without a charter, in an organization for the purpose of affording to the members thereof certain facilities for the transaction of their business as brokers in stocks and securities, and a convenient exchange or sales-room for the conduct of such transactions." (*Belton* v. *Hatch,* 109 N.Y. 593, 596, 17 N.E. 225, 226 (1888))

Today, although far from the private club of old, it is still true that the Exchange is a membership body whose members possess the ultimate authority.

The Exchange Act itself provides:

> "The term 'exchange' means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange." (Sec. 3(a)(1), 15 U.S.C. § 78c(a)(1))

Section 6 imposes upon an exchange a duty to enforce compliance, insofar as possible, with the Exchange Act and rules thereunder *by its members.* The Exchange Act provides:

> "The term '*member*' when used with respect to an exchange means . . . and *includes any firm* transacting a business as broker or dealer of which a member is a partner, and any partner of any such firm." (Sec. 3(a), 15 U.S.C. § 78(a)(3)) (emphasis added)

Thus, Section 3(a)(3) includes within its definition of member the individual member's brokerage organization. By such inclusion the Exchange Act imposes on exchanges the duty to enforce compliance by its member organizations. This duty necessarily extends to all employees, to all owners (investors in a member firm) and to all operations of the member firm which might affect a public customer. Thus, the aggregate of the membership of an exchange, that is, the exchange itself as an entity,* is charged with

* That an exchange is simply the aggregate of its members was recognized in Silver v. New York Stock Exchange, 373 U.S. 341 at 350 (1963): "The exchanges are by their nature bodies with a limited number of members, each of which plays a certain role in the carrying out of an exchange's activities. . . ."

the duty of enforcing the Exchange Act, the rules thereunder and the exchange rules, as against its individual members, their corporations, officers, directors and employees. Those very individuals who as an aggregate are charged with the duty of complying and enforcing compliance are the individuals against whom the public investor is to be protected. Thus, the investors who transact business through an exchange are to be protected by the aggregate exchange membership against its individual members and member organizations, such as Pickard. Pickard should not be able to recover against the other Exchange members for its very own failure to comply.

The effort of the court below to justify its result by distinguishing the corporation from the individuals who act for the corporation is unsupportable. Aside from the particular fact here that all of Pickard's voting shareholders were officers and directors and all were disciplined for their part in Pickard's demise, in performing its Section 6 duties the Exchange can only deal with the member corporation through the individuals who run the firm. If those individuals cause the corporation to violate the rules of the Exchange, appropriate action is taken against the corporation as well as the individuals.

Under the decisions below, the Exchange is confronted with the likelihood of conflicting duties. As noted in *Carr* v. *New York Stock Exchange, supra,* the interests of member firms, their investors, listed corporations and public customers are "often conflicting." ([1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,563 at 99,809) In the past, when the Exchange has learned that a member organization was having difficulty in complying with Exchange rules, it ordinarily intervened to determine the extent of the difficulties. If it determined that the member organization might be able to correct its problems, the Exchange required various remedial steps. *See e.g., Rich*

v. *New York Stock Exchange,* 379 F.Supp. at 1127. These steps are required to protect the customers' accounts, not to protect the capital of the member organization. For instance, it might be in the customer's interest to place restrictions on the business of a firm so that the customer can obtain quicker and more accurate service. On the other hand, such restrictions might reduce profitability to the prejudice of the member organization. Just such restrictions were imposed on Pickard to protect its customers. Despite the best efforts of the Exchange, the member organization might ultimately fail and at that time have less capital than if the Exchange had put it out of business at the first sign of any difficulty and not concerned itself with the fate of the customers' accounts. Permitting a receiver to bring a Section 6 claim on behalf of the defunct member organization for the diminution in capital undercuts the objective of customer protection which is the core of the Exchange Act. Moreover, permitting such claims may force the Exchange to adopt a policy of immediate suspension or expulsion and have a serious disruptive effect on the industry and the economy as a whole. *See Securities Investor Protection Corp.* v. *Barbour, supra,* at 421; *Hughes* v. *Dempsey-Tegeler & Co., Inc., supra,* 534 F.2d at 166-170.

In short, the language of the statute and the legislative history make clear that when Congress enacted Section 6 of the Exchange Act, it intended to protect the public customers *against* the professional brokers and their financial backers. The law is clear that only the intended beneficiaries of a statute may prosecute an implied claim for breach of that statute. Controlling case law and sound public policy require preserving the congressional objective of keeping the public customers, as the intended beneficiaries of Section 6, separate from the professional brokers and their backers. Since that is so, neither Lank nor any member firm or investor in a member firm should be accorded standing by any court to prosecute against an exchange an implied right of action under Section 6 of the Exchange Act.

POINT II

The three year statute of limitations for an action to recover upon a liability created by statute contained in CPLR § 214(2) is applicable to the Receiver's claim under Section 6

The question of the statute of limitations applicable to a claim under Section 6, like the question of standing to assert such claim, has been considered by numerous lower courts without appellate review. Each successive court considering the issue has shown a natural reluctance to dispute a co-equal court's holdings and has built on the prior decisions. Thus, while the Exchange is confident that this case can be disposed of on the standing question, it is important that this Court determine the applicable statute of limitations.

The court below found the limitations period for contract claims to be applicable to Lank's Section 6 claim on the theory that Lank was a third party beneficiary of the Exchange's agreement with the Commission required by Section 6(a) of the Exchange Act. While recognizing that Lank did not plead any such theory and that "the duty has its genesis in the statutory provision" (405 F.Supp. at 1040, JA-234a), the court found the Section 6 duty to be contractual, and the limitation to be the 6 year provision of N.Y. CPLR § 213(2).

In marked contrast, the court in *Wilson* v. *Meyerson*, Civ. No. 72-1298 (N.D.Cal. April 7, 1976) (reproduced in the addendum at p. A-79, at A-82) held:

> "[The] local statute of limitations which governs the tenth count in this instance is Section 338, subdivision 1, of the California Code of Civil Procedure. That statute provides for a three-year period of limitations on bringing '[a]n action upon a liability created by statute, other than a penalty or forfeiture.' The cause of action raised by Section 6 of the Exchange Act was

> unknown at common law; it is therefore squarely within the language of Section 338, subdivision 1."

The reasoning of *Wilson* is by far the sounder.

Since the Exchange Act does not provide a statute of limitations for claims asserted under Section 6, the state statute of limitations applies. *International Union* v. *Hoosier Cardinal Corp.*, 383 U.S. 696, 704-706 (1966); *Cope* v. *Anderson,* 331 U.S. 461 (1947). Here the claim asserted did not exist at common law. *New York Stock Exchange, Inc.* v. *Goodbody & Co.*, 42 A.D.2d 556, 345 N.Y.S.2d 58 (1st Dept. 1973); *Raldiris* v. *Simmons,* 242 App.Div. 603, 271 N.Y.S. 1018 (1st Dept. 1934), *aff'd,* 266 N.Y. 577, 195 N.E. 208 (1935) (decision of trial court reproduced in addendum at p. A-52); *Morganbesser* v. *New York Stock Exchange,* [1971-72 Transfer Binder] CCH Fed.Sec. L. Rep. ¶ 93,210 (Sup.Ct.Nassau Co. 1971); *New York Stock Exchange, Inc.* v. *Pickard & Co.*, 282 A.2d 651 (Del. Ch. 1971); *Krasnow* v. *Kern Securities Corp.*, 175 N.Y.L.J., May 17, 1976, p. 8, col. 6 (Sup.Ct.N.Y.Co.). Where there is no analogous common law action and the action exists because of a statute, the New York cases apply the limitations period for a liability created by statute. *Frank Shepard Co.* v. *Zachary P. Taylor Publishing Co.*, 234 N.Y. 465, 138 N.E. 409 (1923).

As there is no cause of action against an exchange for failing to supervise its members in the absence of Section 6, the action, which is implied from the statute, would not exist but for the statute, and the three year provision of CPLR § 214(2) is applicable. Such a result is required by settled law. *McClaine* v. *Rankin,* 197 U.S. 154 (1905); *Platt* v. *Wilmot,* 193 U.S. 602 (1904); *McCullough* v. *Redevelopment Authority of Wilkes-Barre,* 522 F.2d 858, 867 n.27 (3d Cir. 1975); *Kaiser* v. *Cahn,* 510 F.2d 282, 284-85 (2d Cir. 1974); *City Messenger Service of Hollywood, Inc.* v. *Capitol Records Distributing Corp.*, 446 F.2d 6 (6th Cir. 1971), *cert. denied,* 404 U.S. 1059 (1972);

Schram v. *Cotton,* 281 N.Y. 499 (1939); 53 C.J.S. Limitations of Actions § 83 (1968). The New York courts have adhered to this settled rule. In *Bevelander* v. *Town of Islip,* 10 A.D.2d 170 at 171-72, 199 N.Y.S.2d 561 (2d Dept. 1960), the court said:

> "The term 'a liability created by statute', as employed in this Statute of Limitations, has been defined as 'a liability which would not exist but for the statute' (Shepard Co. *v.* Zachary P. Taylor Pub. Co., 234 N.Y. 465, 468, 138 N.E. 409, 410; see, also Schmidt *v.* Merchants Despatch Transp. Co., 270 N.Y. 287, 305, 200 N.E. 824, 829; 53 C.J.S. Limitations of Actions § 83, subd. (a), p. 1051 *et seq.;* 34 Am. Jur., Limitation of Actions, § 48, p. 48). A proper test of whether a particular liability is 'a governmental statutory denouncement of a human action heretofore undenounced' (Fratt *v.* Robinson, 203 F.2d 627, 635, 37 A.L.R.2d 636)."

Section 6 imposes on exchanges a duty, from which the potential liability is implied, that was unknown at common law. But for Section 6, the duty and, thus, the cause of action asserted by Lank, would not exist. Whether the court looks to Section 6(a)(1) or to Sections 6(b) and (d), the action is derived from the statute. Thus, the three year provision must be applied.

A number of cases cited above considered the situation, such as that in which the Exchange finds itself, where the statute at issue arguably imposed contractual obligations. For example, in *Platt* v. *Wilmot, supra,* the receiver of a national bank sued to recover from the stockholder of a trust company the double liability imposed by reason of his stockholding. Dismissal of the action based on the New York statute of limitations was affirmed, the court noting:

> "We think, within the meaning of section 394, this liability was created by statute, as it was by virtue

> of the statutes that the contractual liability arose. The language of the section plainly includes this case. It is a liability created by the statute, because the statute is the foundation for the implied contract arising from the purchase of or subscription for the stock, the contract being that the holder of the stock shall be liable in accordance with the terms of the statute." (193 U.S. at 613)

When faced with a similar cause of action, the New York courts have followed the same analysis and reached the same conclusion. In *Schram* v. *Cotton, supra,* Judge Lehman found the cause of action barred, holding:

> "A voluntary promise to assume a duty or liability, which the law imposes even where there is no promise, creates no new duty or liability.
>
> * * *
>
> "To hold that action to enforce the statutory liability imposed upon stockholders of the bank, which has been expressly assumed by the stockholders of the dominant corporation, is governed by a different Statute of Limitations from that which governs an action to enforce the statutory liability impliedly assumed by the stockholders of the bank when they acquire their stock, would exalt form over substance." (281 N.Y. at 507)

Application of the contract limitations to Lank's cause of action is just such an exaltation of form over substance.

Indeed, the force of the authorities was recognized by Judge Lasker in his opinion below when he said (405 F.Supp. at 1039, JA-232a):

> "There is appeal to the rather straight-forward proposition that an action based on § 6 of the Securities Exchange Act is one which seeks to recover on a liability created by statute. . . ."

In *Hornblower & Weeks-Hemphill, Noyes* v. *Burchfield,* 366 F.Supp. 1364 at 1367 (S.D.N.Y. 1973), Judge Lasker

considered such a straightforward proposition conclusive in determining the limitation period applicable to a claim under Section 7 of the Exchange Act and Regulation T:

> "[T]he authorities indicate clearly that where a cause of action would not exist but for the presence of a statute which provides a basis for it, the suit is upon 'a liability . . . created or imposed by statute' within § 214(2)."

This action and *Wilson* v. *Meyerson, supra,* are the only two cases which deal with an action based on an alleged breach of the Section 6 statutory duty. As discussed above, *Wilson* and *Lank* are in direct conflict. Several other cases, *Weinberger* v. *New York Stock Exchange,* 335 F.Supp. 139 (S.D.N.Y. 1971); *Carr* v. *New York Stock Exchange,* [1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,563 (N.D. Cal. 1976); *Arneil* v. *Ramsey,* [1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,550 (S.D.N.Y. 1976); and *Fischer* v. *New York Stock Exchange,* [1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,416 (S.D.N.Y. 1976), have considered the statute of limitations applicable to a claim based on Section 6(a) on the theory that plaintiff was the third party beneficiary of the Exchange's agreement with the Commission required by Section 6(a).*

The decisions in *Carr* and *Arneil* followed *Weinberger* without extended analysis. In *Fischer,* another decision by Judge Lasker, the Section 6 claim was barred by both statutes.

The court below reached its decision in part in reliance on *Weinberger* v. *New York Stock Exchange, supra.* (*Weinberger* is the only one of the cases which preceded the decision below.) Although Lank did not plead a contract claim, the court considered it offensive to have different limitations periods applicable to Section 6 claims because of the wording

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* Such an agreement is no longer required under Section 6 as revised by the Securities Reform Act of 1975. See addendum at p. A-2.

of the complaint and ruled that the 6 year statute should apply to any Section 6 claim however pleaded, noting:

> "The obvious distinction between *Weinberger* and the instant case is that Lank has pleaded a statutory and not a contract theory of recovery. However, it offends common sense and the spirit of the Federal Rules to hold that what is for all practical purposes the identical claim should or should not be time barred because of the wording of the complaint." (405 F.Supp. at 1040, JA-234a)

Moreover, the court indicated, in footnote 15, that it would permit plaintiff to amend his complaint to bring himself within the *Weinberger* rationale. (405 F.Supp. at 1040, JA-234a) While the Exchange does not concur with the district court's "reformation" of the complaint, this appeal is not prosecuted on any point of pleading. The appeal is directed to the basic proposition that it is error to apply a contract statute of limitations to any claim arising out of Section 6 no matter what theory the pleader chooses to clothe it in. No matter how the claim is framed, it would not exist but for the statutory provisions and thus the New York cases mandate application of CPLR § 214(2).

Analysis of the *Weinberger* decision indicates that it was constructed only to avoid the bar of the statute. The original complaint in *Weinberger* pleaded a single cause of action for breach of the Exchange's statutory duty under Section 6. The Exchange moved to dismiss the complaint based on the statute of limitations. Before the motion was heard, the plaintiff amended his complaint to plead the Exchange's breach of its "contract" with the Commission required by Section 6(a) and plaintiff's status as a third party beneficiary of that "contract."* On the motion to dismiss, the court, looking to the Restatement of Contracts

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* The pertinent terms of the agreement filed by the Exchange are quoted in the *Weinberger* decision on the merits, 403 F.Supp. 1020 at 1026, where the court found for the Exchange after trial.

§ 145 (1932), and to cases finding a contract for the benefit of third parties drafted pursuant to statutory command, applied the contract period of limitations. However, neither the Restatement, nor the cases relied on in *Weinberger* support the result.

Section 145 of the Restatement says a promisor bound to the United States, or other government body, has no duty to compensate members of the public unless an intention to do so is manifested in the contract. No such intention is manifested in the Exchange's agreement with the Commission. Each of the cases involved a contract separate and apart from the statute, with consideration and obligations running independently of the statute. Although the statutes required certain terms to be included in the contracts, the contract imposed other and further duties and were held to give the plaintiffs separate and different causes of action from those under the statutes. Such is not the case with respect to the agreement filed with the Commission.

The *Weinberger* court (335 F.Supp. at 144 n. 11) held that the agreement required by Section 6 created an independent claim for relief as a third party beneficiary similar to those on behalf of laborers suing a surety on a government construction contract, *United States ex rel. Johnson* v. *Morley Constr. Co.,* 98 F.2d 781 (2d Cir. 1938), or children suing on a loan agreement between defendant and the government, *Lemon* v. *Bossier Parish School Bd.,* 240 F.Supp. 709 (W.D.La. 1965), *aff'd,* 370 F.2d 847 (5th Cir.), *cert. denied,* 388 U.S. 911 (1967). Those cases bear little relation to the matter at hand. Neither *Johnson* nor *Lemon* discussed the limitations period applicable to the claim asserted. They were both concerned with whether or not the action could be maintained by the plaintiff. In each, the contract existed outside of the statute. The only question was whether the plaintiffs were beneficiaries of those contracts. The defendant received benefits and assumed burdens independent of the statute, and the defendant was free to contract or not.

In marked contrast, here the cases are in agreement that the benefits and burdens to the Exchange are those imposed by the statute, and the so-called contractual duty is the same as the statutory duty. *Weinberger* v. *New York Stock Exchange,* 335 F.Supp. at 144 n. 10 and 403 F.Supp. at 1028 n. 2; *Hughes* v. *Dempsey-Tegeler & Co.,* 534 F.2d at 166 n. 5; *Carr* v. *New York Stock Exchange,* [1975-76 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 95,563 at 99,807. It is noteworthy that the courts have reached this conclusion despite the fact that Section 6(a)(1) requires an agreement to enforce compliance, so far as is within its powers, with the Exchange Act and rules thereunder and makes no reference whatsoever to rules of exchanges. Sections 6(b) and (d), on the other hand, require that exchange rules have certain provisions. In rendering his decision on the merits in *Weinberger,* 403 F.Supp. 1020 at 1031-32, Judge Bonsal avoided this plain distinction by finding that since by judicial construction Sections 6(b) and (d) required exchanges to enforce rules, the Section 6(a) agreement to enforce compliance with the Exchange Act includes the Sections 6(b) and (d) implied duty of enforcement of the exchange's rules.

The agreement between the Commission and the Exchange, however, does not satisfy even the most basic criteria for implication of a third party beneficiary right of action. The leading case of *H.R. Moch Co., Inc.* v. *Rensselaer Water Co.,* 247 N.Y. 160, 159 N.E. 896 (1928), establishes the following two tests for finding a third party beneficiary right of recovery under a contract with a governmental entity: (1) that the contract sued upon must evidence an intent that the promisor be answerable to the public and (2) that the benefit to the public must be direct. The agreement here meets neither test.

In *Eastern Air Lines, Inc.* v. *Islip,* 229 N.Y.S.2d 117 (Sup. Ct. Suffolk Co. 1962), the plaintiff claimed to be a third party beneficiary of an agreement between the town and the federal government requiring the town to operate

its airport for the benefit of the public. The court rejected plaintiff's claim, stating at 121-122:

> "No such action is maintainable in the absence of a manifest intent on the part of the defendant to be answerable to the individual members of the public for any loss they might sustain for the defendant's failure to fulfill its promise. I find no such intent expressed in any of the 'Grant Agreements'. The defendant cannot be held as an insurer of all of the members of the public. This principal of the law finds further expression in Section 145 of the Restatement of the Law of Contracts. . . ."

The agreement between the Exchange and the Commission is similarly deficient.

The other two cases relied on in *Weinberger* are equally inapplicable to the facts here. *Fata* v. *S.A. Healy Co.,* 289 N.Y. 401, 46 N.E.2d 339 (1943), was an action by an employee against his employer for the difference between wages he received and those at the prevailing rate. The employee was employed on construction work performed under contract between the employer and the city. The prevailing rate was determined by the fiscal officer of the city pursuant to law and all employees on public works were required by law to be paid the prevailing rate. The contract between the employer and the city included an agreement to pay scheduled wages. The court found the employee entitled to maintain the action on a third party beneficiary theory inasmuch as the obligation undertaken in the separate contract provided a specific, direct benefit to the plaintiff. The court noted that limitations on the statutory obligation would apply to a contractual obligation as well, particularly where the two obligations were stated in the same language. (289 N.Y. at 406) In *Fata,* however:

> "The obligation thus assumed by the contractor is precise, and extends beyond the scope of the statutory obligation. The statutory remedy provided for breach

of the statutory obligation would be an inadequate and unsuitable remedy for a violation of this contractual obligation." (*Id.* at 406-7)

Filardo v. *Foley Bros., Inc.*, 297 N.Y. 217, 78 N.E.2d 480 (1948), was similar to the *Fata* case. The plaintiff was a laborer employed by the defendants on defendants' construction jobs for the United States Government. Plaintiff sought overtime pay. Such pay was required by federal law on all governmental jobs. Additionally, in their contracts with the government, defendants had specifically agreed to abide by all applicable laws. The court found separate statutory and contractual rights to sue. Like *Fata, Filardo* involved a contract independent of the statute with all of the incidents of a contract separate from but incorporating terms of the statute.

In the one case discussed both in *Weinberger* and below, *People* v. *Corcillo,* 195 Misc. 198, 88 N.Y.S.2d 534 (Sup. Ct. Albany Co. 1949), *aff'd,* 276 App. Div. 675, 97 N.Y.S.2d 319, *appeal denied,* 277 App. Div. 911, 98 N.Y.S.2d 592 (3d Dept. 1950), some of the defendants were not even subject to the statute, although they had entered into the contract. Furthermore, there was no cause of action founded on the statute. In contrast, here the agreement is not separate from the statute, the duties are not separable, and the cause of action cannot be.

The decision below was also based on the district court's evaluation of policies underlying the federal securities laws and the court's assumption that such policies favored the longer period. Such an approach can lead to illogic in the law. In other states the limitations period for contract actions might be shorter, longer or the same as that for a liability created by statute. The determination of the applicable statute should not be governed by the court's desire to find the longest one. Indeed, in *Fischer* v. *New York Stock Exchange,* 408 F.Supp. 745 at 757 (S.D.N.Y. January 15, 1976), Judge Lasker said: "[Actions] based on § 6 are in the nature of negligence. . . ."

Thus, the action might be given another label in another case to get some other limitations period. National securities exchanges should not be confronted with such confusion when the choice of the applicable statute is so obvious and rational.

Furthermore, there is no basis for the assumption that policies behind the securities laws favor long periods of limitations. In actions specifically created by the securities laws, Congress has provided short periods of limitations, *e.g.*, Section 13 of the Securities Act of 1933 (earlier of one year from discovery or three years from accrual) and Section 18(c) of the Exchange Act (earlier of one year from discovery or three years from accrual). It is surely a distortion of the policy to search for the longest period for a cause of action that is only implied. The Supreme Court recently has considered the implied cause of action under Section 10(b) and has said that judicially created causes of action should not be extended beyond the clear intent of Congress. *Ernst & Ernst* v. *Hochfelder, supra; Blue Chip Stamps* v. *Manor Drug Stores, supra.* Application of a contract limitations to a Section 6 claim constitutes just such an extension beyond the clear intent of Congress. Indeed, in the Securities Reform Act of 1975 Congress has rejected such an intention by eliminating from Section 6 the requirement of an agreement. (See addendum at p. A-2)

The court below commented, without support in the record, that the 6 year limitation would cause no hardship to the Exchange because of its "extensive record keeping practices." Although the Exchange does endeavor to maintain full and accurate records, under Commission regulations it may destroy those records after 5 years. 17 C.F.R. § 240.17a-1 (1975) Moreover, the Exchange has found that the detailed testimony of live witnesses is essential to Section 6 cases. Obviously memories fade and witnesses become difficult, if not impossible, to locate after such a long period of time as 6 years. In contrast, contract actions are ordinarily based on writings which do not suffer from lapse of time.

Moreover, the court below ignored the very substantial policies behind limitations provisions, which are designed to end the possibility of litigation after the lapse of a reasonable time. Just such policies were recognized by the court in *Wilson* v. *Meyerson, supra,* which had the opinion of Judge Lasker in this action before it but noted, "... by applying the statutes of limitations here it effects a harsh result. Nevertheless, these statutes have a purpose and cannot be ignored. ..." (Addendum at p. A-86)

CONCLUSION

The decision of the court below should be reversed, and the case remanded with a direction that the complaint be dismissed.

Dated: August 13, 1976
New York, N.Y.

Respectfully submitted,

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ADDENDUM

Section 6 of the Securities Exchange Act of 1934, as enacted and in effect at all relevant times

REGISTRATION OF NATIONAL SECURITIES EXCHANGES

Registration of national securities exchanges.

Requirements.

SEC. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

Registration statement; documents to accompany.

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

Disciplinary provisions in rules of exchange.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

Adoption of additional rules by exchange.

(c) Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

Commission authority to grant registration.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

Order to be made within 30 days.

Hearing when denied.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

Filing application deemed date of receipt. Amendments permitted.

Withdrawal of registration by exchange.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

Section 6 of the Securities Exchange Act of 1934, as amended by The Securities Reform Act of 1975

NATIONAL SECURITIES EXCHANGES

SECTION 6. (a) An exchange may be registered as a national securities exchange under the terms and conditions hereinafter provided in this section and in accordance with the provisions of section 19(a) of this title, by filing with the Commission an application for registration in such form as the Commission, by rule, may prescribe containing the rules of the exchange and such other information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) An exchange shall not be registered as a national securities exchange unless the Commission determines that—

(1) Such exchange is so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange.

(2) Subject to the provisions of subsection (c) of this section, the rules of the exchange provide that any registered broker or dealer or natural person associated with a registered broker or dealer may become a member of such exchange and any person may become associated with a member thereof.

(3) The rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.

(4) The rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities.

(5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.

(6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this title, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of

activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

(7) The rules of the exchange are in accordance with the provisions of subsection (d) of this section, and, in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.

(8) The rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

(c)(1) A national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer.

(2) A national securities exchange may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection [of investors] shall, deny membership to any registered broker or dealer or natural person associated with a registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification. A national securities exchange shall file notice with the Commission not less than thirty days prior to admitting any person to membership or permitting any person to become associated with a member, if the exchange knew, or in the exercise of reasonable care should have known, that such person was subject to a statutory disqualification. The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3)(A) A national securities exchange may deny membership to, or condition the membership of, a registered broker or dealer if (i) such broker or dealer does not meet such standards of financial responsibility or operational capability or such broker or dealer or any natural persons associated with such broker or dealer does not meet such standards of training, experience, and competence as are prescribed by the rules of the exchange or (ii) such broker or dealer or person associated with such broker or dealer has engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade. A national securities exchange may examine and verify the qualifications

of an applicant to become a member and the natural persons associated with such an applicant in accordance with procedures established by the rules of the exchange.

(B) A national securities exchange may bar a natural person from becoming a member or associated with a member, or condition the membership of a natural person or association of a natural person with a member, if such natural person (i) does not meet such standards of training, experience, and competence as are prescribed by the rules of the exchange or (ii) has engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade. A national securities exchange may examine and verify the qualifications of an applicant to become a person associated with a member in accordance with procedures established by the rules of the exchange and require any person associated with a member, or any class of such persons, to be registered with the exchange in accordance with procedures so established.

(C) A national securities exchange may bar any person from becoming associated with a member if such person does not agree (i) to supply the exchange with such information with respect to its relationship and dealings with the member as may be specified in the rules of the exchange and (ii) to permit the examination of its books and records to verify the accuracy of any information so supplied.

(4) A national securities exchange may (A) limit the number of members of the exchange and (B) the number of members and designated representatives of members permitted to effect transactions on the floor of the exchange without the services of another person acting as broker: Provided, however, That no national securities exchange shall have the authority to decrease the number of memberships in such exchange, or the number of members and designated representatives of members permitted to effect transactions on the floor of such exchange without the services of another person acting as broker, below such number in effect on May 1, 1975, or the date such exchange was registered with the Commission, whichever is later: And provided further, That the Commission, in accordance with the provisions of section 19(c) of this title, may amend the rules

of any national securities exchange to increase (but not to decrease) or to remove any limitation on the number of memberships in such exchange or the number of members or designated representatives of members permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, if the Commission finds that such limitation imposes a burden on competition not necessary or appropriate in furtherance of the purposes of this title.

(d)(1) In any proceeding by a national securities exchange to determine whether a member or person associated with a member should be disciplined (other than a summary proceeding pursuant to paragraph (3) of this subsection), the exchange shall bring specific charges, notify such member or person of, and give him an opportunity to defend against, such charges, and keep a record. A determination by the exchange to impose a disciplinary sanction shall be supported by a statement setting forth—

(A) any act or practice in which such member or person associated with a member has been found to have engaged, or which such member or person has been found to have omitted;

(B) the specific provision of this title, the rules or regulations thereunder, or the rules of the exchange which any such act or practice, or omission to act, is deemed to violate; and

(C) the sanction imposed and the reasons therefor.

(2) In any proceeding by a national securities exchange to determine whether a person shall be denied membership, barred from becoming associated with a member, or prohibited or limited with respect to access to services offered by the exchange or a member thereof (other than a summary proceeding pursuant to paragraph (3) of this subsection), the exchange shall notify such person of, and give him an opportunity to be heard upon, the specific grounds for denial, bar, or prohibition or limitation under consideration and keep a record. A determination by the exchange to deny membership, bar a person from becoming associated with a member, or prohibit or limit a person with respect to access to services offered by the exchange or a member thereof shall be supported by a statement setting forth the specific grounds on which the denial, bar, or prohibition or limitation is based.

(3) A national securities exchange may summarily (A) suspend a member or person associated with a member who has been and is expelled or suspended from any self-regulatory organization or barred or suspended from being associated with a member of any self-regulatory organization, (B) suspend a member who is in such financial or operating difficulty that the exchange determines and so notifies the Commission that the member cannot be permitted to continue to do business as a member with safety to investors, creditors, other members, or the exchange, or (C) limit or prohibit any person with respect to access to services offered by the exchange if subparagraph (A) or (B) of this paragraph is applicable to such person or, in the case of a

person who is not a member, if the exchange determines that such person does not meet the qualification requirements or other prerequisites for such access and such person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the exchange. Any person aggrieved by any such summary action shall be promptly afforded an opportunity for a hearing by the exchange in accordance with the provisions of paragraph (1) or (2) of this subsection. The Commission, by order, may stay any such summary action on its own motion or upon application by any person aggrieved thereby, if the Commission determines summarily or after notice and opportunity for hearing (which hearing may consist solely of the submission of affidavits or presentation of oral arguments) that such stay is consistent with the public interest and the protection of investors.

(e)(1) On and after the date of enactment of the Securities Acts Amendments of 1975, no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members: Provided, however, That until May 1, 1976, the preceding provisions of this paragraph shall not prohibit any such exchange from imposing or fixing any schedule of commissions, allowances, discounts, or other fees to be charged by its members for acting as broker on the floor of the exchange or as odd-lot dealer: And provided, further, That the Commission, in accordance with the provisions of section 19(b) of this title as modified by the provisions of paragraph (4) of this section, may—

(A) permit a national securities exchange, by rule, to impose a reasonable schedule or fix reasonable rates of commissions, allowances, discounts, or other fees to be charged by its members for effecting transactions on such exchange prior to November 1, 1976, if the Commission finds that such schedule or fixed rates of commissions, allowances, discounts, or other fees are in the public interest; and

(B) permit a national securities exchange, by rule, to impose a schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members for effecting transactions on such exchange after November 1, 1976, if the Commission finds that such schedule or fixed rates of commissions, allowances, discounts, or other fees (i) are reasonable in relation to the costs of providing the service for which such fees are charged (and the Commission publishes the standards employed in adjudging reasonableness) and (ii) do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title, taking into consideration the competitive effects of permitting such schedule or fixed rates weighed against the competitive effects of other lawful actions which the Commission is authorized to take under this title.

(2) Notwithstanding the provisions of section 19(c) of this title, the Commission, by rule, may abrogate any exchange rule which im-

poses a schedule or fixes rates of commissions, allowances, discounts, or other fees, if the Commission determines that such schedule or fixed rates are no longer reasonable, in the public interest, or necessary to accomplish the purposes of this title.

(3) Until December 31, 1976, the Commission, on a regular basis, shall file with the Speaker of the House and the President of the Senate information concerning the effect on the public interest, protection of investors, and maintenance of fair and orderly markets of the absence of any schedule or fixed rates of commissions, allowances, discounts, or other fees to be charged by members of any national securities exchange for effecting transactions on such exchange.

(4)(A) Before approving or disapproving any proposed rule change submitted by a national securities exchange which would impose a schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members for effecting transactions on such exchange, the Commission shall afford interested persons (i) an opportunity for oral presentation of data, views, and arguments and (ii) with respect to any such rule concerning transactions effected after November 1, 1976, if the Commission determines, there are disputed issues of material fact, to present such rebuttal submissions and to conduct (or have conducted under subparagraph (B) of this paragraph) such cross-examination as the Commission determines to be appropriate and required for full disclosure and proper resolution of such disputed issues of material fact.

(B) The Commission shall prescribe rules and make rulings concerning any proceeding in accordance with subparagraph (A) of this paragraph designed to avoid unnecessary costs or delay. Such rules or rulings may (i) impose reasonable time limits on each interested person's oral presentations, and (ii) require any cross-examination to which a person may be entitled under subparagraph (A) of this paragraph to be conducted by the Commission on behalf of that person in such manner as the Commission determines to be appropriate and required for full disclosure and proper resolution of disputed issues of material fact.

(C)(i) If any class of persons, the members of which are entitled to conduct (or have conducted) cross-examination under subparagraphs (A) and (B) of this paragraph and which have, in the view of the Commission, the same or similar interests in the proceeding, cannot agree upon a single representative of such interests for purposes of cross-examination, the Commission may make rules and rulings specifying the manner in which such interests shall be represented and such cross-examination conducted.

(ii) No member of any class of persons with respect to which the Commission has specified the manner in which its interests shall be represented pursuant to clause (i) of this subparagraph shall be

denied, pursuant to such clause (i), the opportunity to conduct (or have conducted) cross-examination as to issues affecting his particular interests if he satisfies the Commission that he has made a reasonable and good faith effort to reach agreement upon group representation and there are substantial and relevant issues which would not be presented adequately by group representation.

(D) A transcript shall be kept of any oral presentation and cross-examination.

(E) In addition to the bases specified in subsection 25(a), a reviewing Court may set aside an order of the Commission under section 19(b) approving an exchange rule imposing a schedule or fixes rates of commissions, allowances, discounts, or other fees, if the Court finds—

(1) a Commission determination under paragraph (4)(A) that an interested person is not entitled to conduct cross-examination or make rebuttal submissions, or

(2) a Commission rule or ruling under paragraph (4)(B) limiting the petitioner's cross-examination or rebuttal submissions, has precluded full disclosure and proper resolution of disputed issues of material fact which were necessary for fair determination by the Commission.

(F) The Commission, by rule or order, as it deems necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to assure equal regulation, may require—

(1) any person not a member or a designated representative of a member of a national securities exchange effecting transactions on such exchange without the services of another person acting as a broker, or

(2) any broker or dealer not a member of a national securities exchange effecting transactions on such exchange on a regular basis,

to comply with such rules of such exchange as the Commission may specify.

Section 19 of the Securities Exchange Act of 1934, as enacted and in effect at all relevant times

POWERS WITH RESPECT TO EXCHANGES AND SECURITIES

Powers over exchanges and securities.

Authority conferred on Commission.

SEC. 19. (a) The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors—

Suspension, etc., of registration of national exchange.

(1) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to withdraw the registration of a national securities exchange if the Commission finds that such exchange has violated any provision of this title or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon.

Of security.

(2) After appropriate notice and opportunity for hearing, by order to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to withdraw, the registration of a security if the Commission finds that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder.

Of member.

(3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of this title or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect of such transaction any provision of this title or the rules and regulations thereunder.

Of trading in registered security.

(4) And if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding ten days, or with the approval of the President, summarily to suspend all trading on any national securities exchange for a period not exceeding ninety days.

Authority to compel amendment of exchange rules.

(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) mini-

Scope designated.

mum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

Commission directed to study rules of exchanges, including discipline.

(c) The Commission is authorized and directed to make a study and investigation of the rules of national securities exchanges with respect to the classification of members, the methods of election of officers and committees to insure a fair representation of the membership, and the suspension, expulsion, and disciplining of members of such exchanges.

Report thereof to Congress.

The Commission shall report to the Congress on or before January 3, 1935, the results of its investigation, together with its recommendations.

The statement and digest presented by Mr. FLETCHER to accompany the bill are as follows:

STATEMENT BY SENATOR DUNCAN U. FLETCHER, CHAIRMAN OF THE SENATE COMMITTEE ON BANKING AND CURRENCY

The bill just introduced for the regulation of securities exchanges is one of the series of steps taken and to be taken for the purpose of bringing safety to the general public in the field of investment and finance. The present step is made necessary by the misfortunes of great numbers of our people who have lost part, or all, of their savings through unregulated stock exchanges. Still more, this bill has been made necessary by the needs of the entire American public that the operation of the securities exchanges shall never again intensify a business depression, or help precipitate a business depression. In brief, we have already received ample evidence through the hearings of the Senate Committee on Banking and Currency, through countless letters addressed to the committee, and in many other ways that the unregulated operation of such great financial machines as the stock exchanges of the country can directly bring heavy losses to investors and can indirectly, by heightening the forces of a depression or by retarding incipient business recovery, affect great bodies of our workers and take from them, or keep from them, their opportunity to have work and to earn a decent living.

It is in the light of the interests of the general public that the bill was drawn. There was no desire to hurt the few hundred men who have been obtaining, year after year, princely incomes out of the pockets of the American people through the operation of exchanges not subject to Government regulation. But while there was no desire to hurt these few men, the bill was drafted on the theory that the interests of the general public are paramount and that an end must be put to any mulcting of the general public for the benefit of a few insiders. The consequence of this legislation is likely to be that the insider who has relied upon his ability to take advantage of the unprivileged outsider will suffer; but this is unavoidable if the American people as a whole are to be protected from such persons. Honest brokers have nothing to fear from the bill. Indeed, they are likely to gain by the cleaning-out process that will follow and by the elimination of unsavory practices, and perhaps by the elimination also of those who have engaged in such practices.

Many of the remedies for existing evils considered in the course of the preparation of this bill go far beyond the provisions incorporated in the bill. Many of the remedies considered but not incorporated in the bill are in themselves sound and desirable. It may be that before the bill is enacted into law a number of the remedies not contained in the present draft of the bill, and far more restrictive than its present provisions, will be proposed by various Members and accepted by the Congress. It should be explained at the present time that in now proposing a number of measures less advanced than those favored by many Members of the Congress, as well as by myself, the purpose has been to submit at the outset a program on which those holding various points of view might be able to reach an agreement. In short, what is now put before the Congress is a moderate or middle-of-the-road program. Of course, it will not be considered either moderate or middle-of-the-road by those who have had financial interests in the special privileges and unsound practices of the past. But when I speak of moderation I am speaking from the point of view of the great mass of the people, who are entitled to receive the prime consideration of the National Legislature.

While compromising on these matters of substance, and with respect to the nature or type of remedies proposed at the outset, there has been no compromise on the issue whether such remedies as are proposed shall become truly effective. In other words, the bill seeks to prevent those devices by which skillful financial lawyers have in past decades been able from time to time to thwart, to hinder, and to delay the will of the Congress. Whatever remedies are proposed in the bill are to be effectuated so thoroughly that there can be no escape for those persons who should not be permitted to escape. The bill goes as far as it reasonably can in assuring our citizenry that the moderate remedies proposed will be thoroughly effectuated.

The bill will, of course, decrease and discourage certain types of activity on the securities markets, and in that sense and to that extent will serve to affect and diminish the volume of stock-exchange activity. Although the bill does not prohibit all speculative activities on stock exchanges, its purpose is to make stock

exchanges market places for investors and not places of resort for those who would speculate or gamble.

The purpose of the bill is to insure to the public that the securities exchanges will be fair and open markets. The bill seeks to protect the American people by requiring brokers on these exchanges, members of these exchanges, to be wholly disinterested in performing their services for their clients and for the American people trading on the exchanges.

Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America. Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors. For example, besides forbidding fraudulent practices and unwholesome manipulations by professional market operators, the bill seeks to deprive corporate directors, corporate officers, and other corporate insiders of the opportunity to play the stocks of their companies against the interests of the stockholders of their companies.

The bill allows the use of ample credit in the conduct of stock exchanges. But it seeks to prevent the recurrence of those abuses which in the past have led to the absorption of the Nation's credit needed for trade and industry into a whirling, gambling stock market. The amounts that margin traders may borrow are limited. The amount of borrowed capital that brokers may use is likewise limited. Bootleg loans in defiance of Federal Reserve policy are brought within the ban of the bill. If the limitations imposed by the bill should not be deemed sufficiently restrictive—and I am sympathetic, indeed, with the view of many persons, both in and out of the Congress, that restrictions should be much higher than those outlined in the bill—there will be ample opportunity of amendment of the bill in the direction of even further protection of the interests of the general public and of trade and industry.

The evidence before the Senate Banking and Currency Committee has demonstrated that those in charge of stock exchanges in the past have not required adequate disclosure by persons and concerns listing or maintaining the listing of securities on the exchanges. At times the excuse has been advanced that exchange officials have not had sufficient power. There can be no question that the American public is entitled to have the fullest disclosure, as a condition to the listing of securities and as a condition to maintaining such listing on the public exchanges. The Federal Government has the power to require this full disclosure, and the bill is so written that the disclosure may now become assured to the great body of our investors.

The bill strikes at a variety of misleading and law-avoiding devices. The great evil involved in the abuse of proxies is dealt with by the bill. Men with small, and sometimes no, financial interest will be unable under this bill to solicit proxies without disclosing their real interest and all their side agreements and special privileges and special relationships, of which the stockholders of the companies should be fully informed. Economic bosses can no longer seek in the name of private enterprise to misuse positions of power and trust. The provisions of the bill on this subject strike the first blow at a system that has given a small and willful group of men control over the properties and savings of the great mass of investors.

The stock exchanges will be given opportunity to enforce the standards of conduct laid down in this legislation and such other standards consistent with it as they may deem proper. But if the exchanges fail in the future as they have failed in the past to maintain proper standards, the penalties of the criminal law and effective civil liabilities attach in order to insure that the standards laid down by the bill will be living standards and not a mere dead letter of the law. When this legislation goes into effect, privileged insiders who unjustly get money from the general public can be compelled to restore that money to those who lost it. The financial market places of this country will be cleansed and made safe for honest investors.

DIGEST OF STOCK EXCHANGE BILL

The first section provides that the act may be cited as the "National Securities Exchange Act of 1934."

Section 2 contains a declaration of the intimate relationship which prices of transactions on securities exchanges bear to transactions in interstate commerce, the danger of excessive speculation and the manipulation of such prices, and their effect upon the general credit of the country, especially with regard to excessive fluctuations. Transactions on stock exchanges are thus affected with a national and public interest which requires regulation of the conduct of business upon securities exchanges.

Section 3 contains definitions of important words used in the act, including "exchange" and "interstate commerce", and states that the "Commission" (which is given extensive powers in administration of the act) shall be the Federal Trade Commission.

Section 4 prohibits the use of the mails or interstate commerce for the purpose of effecting any transaction in a security on an exchange or of reporting such transaction unless the exchange has been registered as a "national securities exchange."

Section 5 provides a procedure for the registration of "national securities exchanges." Exchanges may be registered as such only if they furnish the Federal Trade Commission full information concerning their organization and rules and satisfy the Commission that they are so organized as to be able to comply with the provisions of this act and the regulations of the Commission.

Section 6 provides that all purchases made through members of exchanges must be secured by a margin of at least 60 percent of the current market price or 20 percent of the lowest price at which such security has sold during the preceding 3 years. The Commission is given authority to prescribe more rigid margin requirements at any time when it deems that this is appropriate in the public interest or for the protection of investors. No person shall extend credit on any security which is traded on a national securities exchange without conforming to the margin requirements which this section imposes on members of such an exchange.

Section 7 places restrictions on borrowing by members of exchanges and dealers and brokers who act through them and on their use of customers' securities. They may not borrow on a security registered on a national securities exchange except from a member bank of the Federal Reserve System, and the total amount of their borrowing is limited. They cannot hypothecate or lend securities carried for customers except in accordance with the customers' consent and to a reasonable and fair extent.

Section 8 makes it criminal to manipulate the prices of securities on national securities exchanges. The devices expressly outlawed are:

(1) Washed sales.
(2) Matched orders.
(3) Any combination of purchases and sales made for the purpose of raising or depressing the price of the security or creating a false impression as to the market of such security.
(4) The spreading of rumors that prices will change in accordance with activities of manipulators.
(5) Disseminating misleading information regarding a security.
(6) Paying for the dissemination of information in aid of the operations of manipulators.
(7) Pegging the price of a security without informing the Commission as to all the details of the operation.
(8) Cornering the supply of a security.
(9) The use of options and trading against options.

Subsections (b) and (c) provide for civil liability of manipulators to persons injured by their market operations.

Section 9 prohibits short selling or stop-loss orders in connection with securities traded on national securities exchanges except in compliance with regulations which the Commission may prescribe. The Commission is also given power to forbid any other devices in connection with security transactions which it finds detrimental to the public interest or to the proper protection of investors.

Section 10 prohibits members and persons engaged in a securities business who act through members to be underwriters of securities or dealers, as distinguished from brokers. Members cannot act as specialists unless registered as such, and specialists may not execute orders except at fixed prices, nor can they disclose confidential information.

Section 11 requires registration of securities which are admitted to trading on national securities exchanges. Such registration must be made with the exchange and with the Commission. The Commission shall prescribe regulations regarding registration, which shall include disclosure of such details concerning the financial position of the company and other facts, similar to those required to be disclosed under the National Securities Act of 1933, as the Commission may prescribe.

Section 12 includes the further provision that annual, quarterly, and monthly reports must be furnished, keeping such information up to date.

Section 13 prohibits the use of the mails or interstate commerce in connection with proxies for securities registered on national securities exchanges unless such information with regard to the proxies and plans of the proxies shall be filed with the Commission, as the Commission may require.

Section 14 makes it unlawful to conduct any over-the-counter market for any securities except in compliance with regulations which the Commission may prescribe.

Section 15 compels the disclosure of the holdings and dealings of directors, officers, and principal stockholders in the securities of the corporation. Such persons are also prohibited to speculate in the securities of the corporation or to sell them short. Profits

resulting from speculation shall be recoverable by the corporation.

Section 16 requires that every national securities exchange, its members, and brokers and dealers who transact business through such members, shall keep detailed accounts of all transactions. These records shall be open at all times to inspection by the Commission, which is also permitted to have its inspectors on the premises of exchanges and at meetings of exchange committees.

Section 17 imposes civil liability for false or misleading statements in any of the reports or records required under this act.

Section 18 enumerates various powers of the Commission. In general, it may make regulations for the carrying into effect of all provisions of the act and governing the conduct of business on exchanges as it may deem necessary. The Commission is also given extensive powers of investigation similar to those which it enjoys under the National Securities Act.

Section 19 provides that persons who control others subject to the provisions of the act and regulations thereunder shall likewise be subject themselves. Not only does it cover the usual devices, such as dummy corporations, but provides that when a member of the immediate family of a person forbidden to make a given transaction in a security effects such a transaction, the person forbidden shall have the burden of showing that the transaction was not an attempted evasion of the act.

Section 20 deals with the procedure for injunctions and prosecutions of offenses, which is similar to that under the Securities Act, and gives the Commission power to suspend the registration of an exchange or of a security for failure to comply with the provisions of the act and regulations thereunder.

H.R. Rep. No. 1613, 91st Cong., 2d Sess. 1-10 (1970)

SECURITIES INVESTOR PROTECTION ACT OF 1970

October 21, 1970.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. Staggers, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

[To accompany H.R. 19333]

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 19333) to provide greater protection for customers of registered brokers and dealers and members of national securities exchanges, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert a new text which appears in the reported bill in italic type.

Purpose of Legislation

The primary purpose of the reported bill is to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles. In these circumstances public customers sometimes encounter difficulty in obtaining their cash balances or securities from the broker-dealers. Sometimes it is just a matter of time until the liquidation is completed, but, unfortunately, in some situations the customer never fully recovers that to which he is entitled. The proposed legislation would provide for the establishment of a fund to be used to make it possible for the public customers in the event of the financial insolvency of their broker, to recover that to which they are entitled, with a limitation of $50,000 for each customer on the amounts to be provided by the proposed fund.

In addition, the legislation mandates a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.

Background and Need for This Legislation

The serious and persistent financial problems besetting the securities industry in recent months have led to the voluntary liquidations, mergers, receiverships or, less frequently, bankruptcies of a substantial number of brokerage houses. Such failures may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the U.S. securities markets. Such lessened confidence has an effect on the entire economy. Whatever other steps must be taken to improve these conditions, one objective of the bill, as reported, is to provide investors protection against losses caused by the insolvency of their broker-dealer. The need is similar, in many respects, to that which prompted the establishment of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

As the Congress recognized in 1933 when it enacted the first Federal Securities Act, ". . . securities are intricate merchandise." (H.R. Rep. No. 85, 73d Cong., 1st sess., May 4, 1933.) So, too, it has come to be recognized that the securities business is an intricate business. In some respects the industry is unique, and its problems and practices require original solutions. Broker-dealers, among their many obligations, are responsible for safeguarding billions of dollars in cash and securities which belong to investors. There are today in this country over 26 million shareholders, many of whom have either cash or securities or both in the custody of broker-dealer firms.

Free credit balances are funds left with a broker-dealer firm by customers who have an unrestricted right to withdraw them on demand. This money usually comes from the proceeds of the sale of customer's securities or from dividends paid. It is left on deposit with the broker largely as a convenience. These funds may be and are used by broker-dealers to maintain positions in securities, to finance margin purchases of other customers, and to operate their business generally. Only rarely, is interest on these funds paid by the broker to the customer. At the present time it is estimated that approximately $2 billion of customer money is on deposit under these circumstances with members of the New York Stock Exchange alone. This estimated figure represents a drop, however. The estimated total for the beginning of 1970 was $2.8 billion, and the comparable estimate for early 1969 was $3.7 billion.

Broker-dealers also hold substantial amounts of customer securities for safekeeping. While customers have an unrestricted right to receive on demand these securities which belong to them and are fully paid for, there is an inevitable risk that they may be transferred improperly or may be reached by creditors of the broker-dealer if the difficult and technical legal requirements of "segregation" are not observed. Moreover, securities which are not fully paid for—that is, margin securities--are held by the broker-dealer and may be pledged by the broker as collateral on bank loans. While figures are not available regarding the total value of securities so held, the largest brokerage firm in this country recently held about $18 billion in customer securities for safekeeping. By contrast, the total assets of the firm were about $1.8 billion.

There are some safeguards, however, on both the State and Federal levels as well as in industry imposed regulations. At the Federal level brokers and dealers are required to register with the Securities and

Exchange Commission (the "Commission") and maintain certain minimum capital requirements. They must limit their aggregate indebtedness in relation to their net capital in order to enable such firms to maintain prescribed minimum standards of liquidity and financial responsibility. They may also hypothecate or loan a customer's securities only under certain prescribed conditions, including a limitation of hypothecation of customers securities to the aggregate amount owed the broker by customers. They are required to maintain and preserve accurate books and records and to report to the customer concerning transactions in his account.

Member firms of registered exchanges are also required to furnish to the customer whose free credit balances are used, statements disclosing the amount due to the customer, the fact that such funds are not segregated and may be used by the firm in its business, and that such funds are payable to the customer on demand. In addition, certain exchanges, as well as the National Association of Securities Dealers, require segregation and identification of customer securities. Under the New York Stock Exchange's rules, for example, customers' excess margin and fully paid securities must be physically separated from usable margin and firm securities, and their ownership specifically identified. This is most frequently accomplished by the bulk segregation method.

While the totality of the rules and regulations noted above provide important protections for investors, it is clear that these rules are not sufficient by themselves to prevent the exposure of customers to substantial risk of loss as a result of financial mismanagement by a firm or its employees or insolvency.

The industry itself is aware of the implication of this. In the wake of the collapse of Ira Haupt & Co., a New York Stock Exchange member firm, that Exchange established in 1964 a trust fund to protect customers of its member firms. Other exchanges have followed this step. However, for a number of reasons, such protection has not proved to be sufficiently comprehensive to maintain investor confidence. First, the instruments establishing the trust funds provide that their use is discretionary and that the trustees have no legal obligation to the customers of member firms. Second, the trust fund of the New York Stock Exchange is now virtually exhausted, having been required to commit approximately $55 million, which includes $30 million transferred from the Exchange's building fund in the spring of this year. Finally, no trust fund has been established to protect investors who deal with a broker who is not a member of any exchange.

Unfortunately, since August of this year, three members or former members of the New York Stock Exchange have been forced to go into bankruptcy or to commence liquidation proceedings. As of this date, the Exchange has not undertaken to protect the customers of the firms with funds from the trust fund. In refusing to do so the Exchange has cited the voluntary nature of the trust fund and the apparent exhaustion of the money available. As of this moment, therefore, customers of those firms must face the spectre of not only inevitable delay in receiving their funds and securities, but also the possibility of never receiving all to which they are entitled.

This legislation, therefore, is designed to effect two aims. It will establish immediately a substantial reserve fund which will provide protection to customers of broker-dealers similar to that formerly

provided by the exchange trust funds. This will reinforce the confidence that investors have in the U.S. securities markets. In addition, the reported bill would provide for a strengthening of the financial responsibilities of broker-dealers.

History of Bill

H.R. 13308 and H.R. 17585 were identical bills introduced by Congressman John Moss (California) on August 4, 1969, and Congressman Bertram Podell (New York) on May 12, 1970, respectively. Hearings were held by the subcommittee on Commerce and Finance in June and July 1970. During the course of those hearings various industry and Commission proposals were presented to the subcommittee and subsequently introduced. H.R. 18081, introduced on June 16, 1970, was the Commission's proposal. H.R. 18109, introduced on June 17, 1970, was the proposal of the Joint Securities-Industry Task Force. H.R. 18458, introduced on July 14, 1970, was, with certain modifications, the joint proposal of the Commission and the Industry Task Force.

After subcommittee deliberations on these bills, the subcommittee reported a clean bill to the full committee. This bill, H.R. 19333, introduced on September 17, 1970, was jointly sponsored by every member of the subcommittee.

The full committee, after considering the bill, ordered it reported with one amendment which strikes all after the enacting clause and substitutes a text which makes numerous technical amendments and corrections to the bill as originally introduced.

The Securities Investor Protection Corporation

The reported bill would create a Securities Investor Protection Corporation (SIPC) which would be a nonprofit, membership corporation. It would not be an agency or establishment of the U.S. Government and, in addition to the powers granted by the bill, would have all the powers conferred upon a nonprofit corporation by the District of Columbia Nonprofit Corporation Act (D.C. Code, sec. 29-101 et seq.).

Membership in the corporation would consist of all brokers and dealers registered under section 15(b) of the Securities Exchange Act of 1934 and all persons who are members of a national securities exchange, except that persons whose business as a broker or dealer consists exclusively of the distribution of shares of mutual funds or variable annuities, would not be included in membership.

Establishment of SIPC Fund

1. *Initial fund*

The bill, as reported, provides that, within 120 days from the date of enactment, SIPC would have a fund which would aggregate not less than $75 million. It is contemplated that this fund would consist of $10 million in cash and $65 million in a confirmed line of credit from banks. This line of credit is currently being negotiated by representatives of the securities industry, and at the present time the parties involved report to your committee that they are most optimistic that this line of credit will be satisfactorily obtained consistent with the requirements of the reported bill.

The $10 million in cash would be raised by an initial assessment on all members of SIPC as well as a transfer of certain funds from existing trust funds of some of the national securities exchanges. The initial assessment on each member of SIPC would be set by the legislation at one-eighth of 1 percent of gross revenues from the securities business (as defined in the bill) during 1969. This assessment would be payable on or before the 120th day following the date of enactment. It is anticipated that this assessment will produce approximately $7 million. The transfers from existing trust funds will produce approximately $3 million.

2. Buildup and ultimate size of fund

The reported bill would set $150 million, or such larger amount as the Commission may determine to be in the public interest, as the projected fund size. Until the fund totals that amount, SIPC would be required to impose an assessment on its members equal to one-half of 1 percent per annum of gross revenues from the securities business.

The bill also requires that, after 3 years from the date of enactment, the fund may not include more than $50 million in confirmed lines of credit from banks and further requires that, once the fund aggregates $150 million (in cash and confirmed lines of credit), SIPC would be obligated to phase out of the fund all confirmed lines of credit. During this phaseout period, SIPC would be required to endeavor to impose assessments in such a manner that the aggregate assessment payable by its members would be not less than one-fourth of 1 percent of aggregate gross revenues from the securities business. SIPC would be required to maintain assessments at that level unitl the fund aggregates $150 million in cash (exclusive of confirmed lines of credit). In addition, SIPC would be required to impose assessments at this level (¼ of 1 percent) at any time in the future that the fund would drop below $150 million in cash, exclusive of confirmed lines of credit.

The bill, as reported, would also require that the assessment imposed by SIPC be at a level of one-half of 1 percent of gross revenues from the securities business: (1) during any period when there are outstanding borrowings from either a bank or the U.S. Treasury (see sec. 3, infra.), and (2) whenever the amount in the fund (exclusive of confirmed lines of credit) falls below $100 million.

These assessment provisions are designed to develop the fund, as rapidly as feasible, to a total amount of $150 million, in cash and credit, and then to provide for a phaseout of the confirmed lines of credit and a buildup to $150 million in cash. On the basis of the best information available to your committee, it is believed that a fund of the size contemplated by these provisions should be more than sufficient to meet the problems likely to be encountered. However, two stopgap measures are provided. First, the Commission may require a larger fund size if it determines that to be in the public interest. Second, the proposed legislation would provide for U.S. Treasury funds to be loaned to SIPC under certain limited circumstances.

3. Borrowing authority

SIPC would be authorized to borrow from private capital markets when necessary. SIPC would also be authorized to borrow up to $1 billion indirectly from the U.S. Treasury. Such loans would be techni-

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cally effected through the Commission. Loans could be granted to SIPC by the Commission, but only after the Commission had determined that the loan was necessary for the protection of customers of brokers and dealers and for the maintenance of confidence in the U.S. securities markets. In addition, SIPC would have to submit to the Commission a plan to provide as reasonable assurance of prompt repayment as may be feasible under the circumstances. Under the provisions of the reported bill, the Commission would then be authorized to borrow the funds from the Treasury by issuing to the Secretary of Treasury notes or other obligations for the amount of such borrowings. Such notes would bear interest at a rate determined by the Secretary of the Treasury. Thereafter, the funds would be loaned by the Commission to SIPC.

If the Commission determines that the assessments imposed by SIPC would not provide for sufficiently prompt repayment of such notes or obligations, the Commission may, by rule or regulation, impose upon the purchasers of equity securitites a transaction fee that could not exceed one-fiftieth of 1 percent of the purchase price of the securities (that is, 20 cents per $1,000). Transactions of $5,000 or less could be exempt, however, from this transaction fee. This would cause the incidence of this fee to fall largely on the institutional or other substantial investor and only to a minor extent upon the small investor.

Your committee has set the Treasury borrowing authority at $1 billion as a figure unlikely to be required in any situation except one of extreme financial stress. For protection of the type contemplated by this bill, provisions for the most extreme situation—no matter how remote—should be made. Your committee believes that these provisions accomplish that end.

4. Scope of assessments

The assessment authority of SIPC is one of the critical features of this legislation. The bill, as reported, provides that SIPC may impose assessments (1) based on gross revenues from the securities business, or (2) based on any or all of certain factors enumerated, namely: (1) the amount or composition of gross revenues from the securities business, (2) the dollar volume of transactions effected, (3) the number of customer accounts maintained, (4) the amounts of cash and securities in such accounts, (5) the member's net capital, (6) the nature of the member's activities and the consequent risks, or (7) other relevant factors.

Obviously, during periods when the maximum assessment rate of one-half of 1 percent of gross revenues from the securities business is in effect, all assessments will be based on that one factor. However, during other periods when assessments are being made, your committee expects that all members of SIPC would not pay the same assessment rate. SIPC, subject to Commission oversight, would be expected to endeavor to develop a formula or formulae by which assessments would be geared to any or all of several risk factors as well as other factors.

A broad definition of gross revenues from the securities business has been set forth in section 4(i) of the legislation, where 11 sources of gross revenues are enumerated. It is the intent of your committee that each source be computed separately (but without duplication). There-

fore, a loss in one area cannot be taken as a set-off in another, and no provision has been made for a carryover from year to year. The enumerated sources are:

(1) Commissions earned in securities transactions; (2) charges for executing and clearing transactions; (3) net realized gain from principal transactions in trading accounts; (4) net profit from the management of or participation in the underwritings or distribution of securities; (5) interest earned on customers' securities accounts; (6) fees for investment advice or supervision of accounts except to the extent that they relate to services rendered to a mutual fund or insurance company separate account; (7) fees for the solicitation of proxies, tenders, or exchanges; (8) income from service charges or other surcharges with respect to securities; (9) dividends and interest received on securities in investment accounts (except as otherwise provided by rule by the Commission); (10) fees in connection with put, call, and other option transactions; and (11) fees and other income for all other investment banking services

In addition, the bill, as reported, would include in the term securities only those real estate, or oil, gas, or other mineral rights which have been registered under the Securities Act of 1933.

Your committee determined to remove from the assessment provisions revenues derived from certain sources, namely (1) the business of insurance, (2) the distribution of mutual fund shares and variable annuities, (3) the rendering of investment advisory services to mutual funds or insurance company separate accounts, and (4) activities in the capacity of agent for the Federal Reserve Board in the distribution of U.S. Treasury bonds, bills or notes by members formally recognized as a reporting dealer by the Federal Reserve Board.

With respect to items (2), (3) and (4) above, your committee reached these determinations not because it made a judgment that such activities are or are not properly considered to be broker-dealer activities, but rather because it seemed appropriate—for other reasons—not to include them in the assessment schedule. With respect to items (2) and (3), your committee was of the opinion that there are found on both sides of these transactions persons in the status of investors rather than an investor and a person who is an operator within the market fraternity—that is, one who depends upon the operations of the market and benefits substantially by a healthy and viable marketplace.

With respect to item (4), your committee sought to protect those dealers who are formally recognized as reporting dealers by the Federal Reserve Board from suffering competitive disadvantage with certain commercial banks who are also recognized as reporting dealers with the Federal Reserve Board.

These revenues were removed from the assessment scheme by providing (1) that persons who would otherwise be members of SIPC but who engage exclusively in certain of these four activities would be exempt from membership in SIPC, and that, as to those who engage in these activities but not exclusively, (2) revenues from these activities not be included in gross revenues from the securities business, and (3) SIPC not use the other factors permitted to be considered in setting assessments in such a way as to include any of these activities.

The bill provides that the maximum assessment upon any member for any 12-month period that could be imposed by SIPC would be

one-half of 1 percent of such member's gross revenues. The bill further provides that under three specified conditions SIPC would be required to impose assessments at that level. Under two specified conditions SIPC would be required to endeavor to impose assessments in such manner that the aggregate assessment payable by its members would be not less than one-fourth of 1 percent of aggregate gross revenues. (See section 2, above.)

During other times it is anticipated that SIPC would impose such assessments as it deems necessary and appropriate (subject, of course, to the limitations set forth in the legislation). So long as it is possible to maintain the fund at the required levels, SIPC need not impose any assessment. During the initial time period the rate of assessment will, in effect, be in excess of one-half of 1 percent because of the one-time initial start-up assessment of one-eighth of 1 percent of gross revenues for 1969 and the subsequent assessment of one-half of 1 percent of gross revenues.

Function of SIPC

If SIPC determines that any of its members has failed or is in danger of failing to meet its obligations to customers and that one or more of certain specified conditions exist, then it would apply to a court of competent jurisdiction for a decree adjudicating that the customers of such member are in need of the protections provided for by this legislation. The conditions specified in the bill are as follows:

(1) Insolvency, within the meaning of the Bankruptcy Act, or inability to meet obligations as they mature;

(2) That the member has committed an act of bankruptcy;

(3) That the member is subject to a proceeding in which a receiver, trustee, or liquidator has been appointed;

(4) That the member is not in compliance with applicable requirements of law with respect to financial responsibilities of broker-dealers or hypothecation of customer securities; or

(5) That the member is unable to make such computations as may be necessary to establish compliance with financial responsibility or hypothecation rules.

The court, after such adjudication, would appoint such persons as SIPC would specify to serve as trustee for purposes of liquidation of the business of the member. The trustee would be obligated to carry out the liquidation, meeting all the requirements set forth by the reported bill. SIPC would advance to the trustee such sums from the SIPC fund as would be necessary to provide for prompt payment of claims of customers of the debtor, but only to the extent of $50,000 for each customer. This significant provision will make it possible for public customers to receive promptly that to which they are entitled without the delay entailed in waiting for the liquidation proceeding to be completed. In addition, and subject to the limitation of $50,000, public customers of the broker-dealer would receive back 100 percent of that to which they are entitled. It is, of course, hoped and contemplated that, when the liquidation proceedings are completed, SIPC will receive back some moneys from the trustee.

Liquidation Proceedings

The bill, as reported, establishes procedures for the prompt and orderly liquidation of SIPC members when required. The liquidation of stockbrokers is at present governed by section 60e of the Bankruptcy Act (11 U.S.C. 96), enacted in 1938. Over the years certain shortcomings in section 60e have become apparent (see, for example, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st sess., ch. III, pt. 1, p. 410 et seq., 1963). Because payments of SIPC funds to customers of SIPC members in liquidation can be made only as an integral part of liquidation proceedings, the bill provides that SIPC members will be liquidated in special proceedings outside the Bankruptcy Act. In so doing, the bill also seeks to remedy the shortcomings in section 60e referred to above.

Subject to specified conditions, the bill provides that liquidation proceedings under this legislation will be conducted in accordance with, and as though they were being conducted under, certain prescribed provisions of he Bankruptcy Act. In addition, the bill uses certain terms defined in section 60e with the meanings there established, except as further defined in the reported bill.

The bill provides that, if a SIPC member with respect to whom an application is filed (hereinafter called a debtor) consents to or fails to contest the application or fails to show facts sufficient to controvert any material allegation of the application, the court is required to appoint for the debtor a trustee designated by SIPC. An application by SIPC may be filed notwithstanding the pendency of any bankruptcy, receivership or other similar proceedings, and all such proceedings are required to be stayed pending and upon appointment of a trustee.

The reported bill directs the trustee to complete open securities transactions for public customers. In the opinion of your committee, the completion of such transactions will be in the interest of the public as well as investors. It is designed to minimize the disruption caused by a failure of a broker-dealer, precluding the "domino effect" of such failure. Accordingly, the bill requires the trustee to complete all the debtor's open contractual commitments relating to securities transactions in which a customer had an interest. Experience may show that there are certain types of customer transactions which should not be completed, and certain types of noncustomer transactions which should be completed. The Commission is, therefore, given rulemaking authority to prohibit or direct completion of these types of transactions. Completion essentially involves a question of the adequacy of working capital. Accordingly, if and to the extent the debtor's available funds are insufficient to complete transactions. SIPC is to provide the funds, with reimbursement to be made to it on a priority basis.

Your committee also believes that it is in the interest of customers of a debtor that securities held for their account be distributed to them as rapidly as possible in order to minimize the period during which they are unable to trade and consequently are at the risk of market fluctuations. The bill requires the trustee to publish and mail notice of liquidation proceedings to customers and, with certain exceptions, requires claims to be filed during a period fixed by the court, but not

more than 60 days after publication of the notice. To the extent not previously distributed, securities would be distributed promptly upon the expiration of this period.

Section 60e provides for the return to customers of fully paid securities which are "specifically identifiable" as their property. The bill carries forward the 60e concept of specific identification except that, among other things, identification need be made only as of the filing date of the application for appointment of a trustee and except that the bill makes it clear that securities held in bulk segregation or in central certificate services are specifically identifiable. To provide for future developments in the processing and custody of securities, the bill gives the SEC rulemaking authority to establish other types of custody which would constitute specific identification.

Section 60e also provides that property held for customers (other than specifically identifiable property) constitutes a single and separate fund in which customers of the debtor are entitled to share ratably. This concept is carried forward in the bill, except that it is intended that, to the extent possible, the trustee will deliver to a customer against his claim for securities, the same securities (that is, securities of the same issuer, class, and series) which were held for his account on the filing date. For purposes of valuing claims of customers for securities and the extent to which they have been discharged, securities will be valued as of the filing date. To the extent that property in the single and separate fund is insufficient to discharge claims of customers payable out of that fund, SIPC is required to advance funds to the trustee to discharge such claims. SIPC would not be required to advance more than $50,000 per customer. For this purpose a broker-dealer is not considered a customer of the debtor except to the extent that claims of such broker-dealer arise out of transactions for customers of such broker-dealer, in which event, each such customer is deemed a separate customer of the debtor.

The bill, as reported, gives the trustee the powers of a trustee in bankruptcy and of a trustee in a chapter X reorganization. Your committee considers it appropriate to vest the trustee with the latter reorganization powers because such powers will be required to operate the business of the debtor pending completion of open transactions, and the delivery of cash securities to customers. The bill specifically provides that no plan of reorganization may be formulated. Reports to the court by the trustee are to be in such form and detail as shall be determined by the Commission, having regard to the recordkeeping requirements under the Securities Exchange Act of 1934, and the magnitude of items and transactions involved in the securities business.

In general, the court in which an application is filed is vested with the powers of a court in a chapter X reorganization and certain powers of a trustee in bankruptcy. The court is specifically denied the power to abrogate the rights of setoff provided in section 68 of the Bankruptcy Act or the right to enforce a valid, nonpreferential lien, but it may stay enforcement of such rights for an appropriate period of short duration.

H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 1-16 (1934)

SECURITIES EXCHANGE BILL OF 1934

April 27, 1934.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

Mr. Rayburn, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

[To accompany H.R. 9323]

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 9323) to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes, report favorably thereon without amendment and recommend that the bill do pass.

I. Introductory Statement

THE PRESIDENT'S MESSAGE AND LETTER

On February 9, 1934, the President sent the following message to Congress:

To the Congress:

In my message to you last March proposing legislation for Federal supervision of national traffic in investment securities I said: "This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges."

This Congress has performed a useful service in regulating the investment business on the part of financial houses and in protecting the investing public in its acquisition of securities.

There remains the fact, however, that outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pay envelop or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corporations with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in loss to the average investor, who is of necessity personally uninformed.

★ 4-28-34

The exchanges in many parts of the country which deal in securities and commodities conduct, of course, a national business because their customers live in every part of the country. The managers of these exchanges have, it is true, often taken steps to correct certain obvious abuses. We must be certain that abuses are eliminated and to this end a broad policy of national regulation is required.

It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.

FRANKLIN D. ROOSEVELT.

THE WHITE HOUSE, *February 9, 1934.*

On March 26, 1934, the President sent the following letter to the chairman of this committee:

THE WHITE HOUSE,
Washington, March 26, 1934.

Hon. SAM RAYBURN,
Chairman Interstate and Foreign Commerce,
House of Representatives.

MY DEAR MR. CHAIRMAN: Before I leave Washington for a few days holiday, I want to write you about a matter which gives me some concern.

On February 9, 1934, I sent to the Congress a special message asking for Federal supervision of national traffic in securities.

It has come to my attention that a more definite and more highly organized drive is being made against effective legislation to this end than against any similar recommendation made by me during the past year. Letters and telegrams bearing all the earmarks of origin at some common source are pouring in to the White House and the Congress.

The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929.

I have been definitely committed to definite regulation of exchanges which deal in securities and commodities. In my message I stated, "it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations."

I am certain that the country as a whole will not be satisfied with legislation unless such legislation has teeth in it. The two principal objectives are, as I see it—

First, the requirement of what is known as margins so high that speculation, even as it exists today, will of necessity be drastically curtailed; and

Second, that the Government be given such definite powers of supervision over exchanges that the Government itself will be able to correct abuses which may arise in the future.

We must, of course, prevent insofar as possible manipulation of prices to the detriment of actual investors, but at the same time we must eliminate unnecessary, unwise, and destructive speculation.

The bill, as shown to me this afternoon by Senator Fletcher, seems to meet the minimum requirements. I do not see how any of us could afford to have it weakened in any shape, manner, or form.

Very sincerely,

FRANKLIN D. ROOSEVELT.

THE GENERAL PURPOSES OF THE BILL

To reach the causes of the "unnecessary, unwise, and destructive speculation" condemned by the President's message, this bill seeks to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges.

The bill is conceived in a spirit of the truest conservatism. It attempts to change the practices of exchanges and the relationships between listed corporations and the investing public to fit modern conditions, for the very purpose that they may endure as essential elements of our economic system. The lesson of 1921–29 is that without changes they cannot endure.

The bill is not a moral pose or a vengeful striking back at brokers for the losses which nearly the entire Nation has suffered in the last 5 years. Nor is its purpose or effect to regiment business in any way. It is simply an earnest attempt to make belated intelligent adjustments, long required by changing conditions, in a faulty system of distributing shares in corporate enterprise among the public—a system which from the coldly objective viewpoint of the welfare of a conservative public simply has not worked. The out-of-date unsuitability to post-war conditions of a whole series of economic interrelationships of which the stock exchanges are the nerve center has uncontrollably accentuated natural moderate fluctuations of our economic system into mad booms and terrible depressions. And such booms and depressions constitute a more real danger to the stability of a moderate, honest, individualistic state than all the unsound theories in the world. This bill seeks to save, not destroy, stock markets and business by making necessary changes in time.

The fundamental fact behind the necessity for this bill is that the leaders of private business, whether because of inertia, pressure of vested interests, lack of organization, or otherwise, have not since the war been able to act to protect themselves by compelling a continuous and orderly program of change in methods and standards of doing business to match the degree to which the economic system has itself been constantly changing—changing in the proportion of the wealth of the Nation invested in liquid corporate securities traded in on the stock exchanges, changing in the relationship of the distribution of securities and the trading in securities to the balanced utilization of the Nation's credit resources in the financing of agriculture, commerce, and industry. The repetition in the summer of 1933 of the blindness and abuses of 1929 has convinced a patient public that enlightened self-interest in private leadership is not sufficiently powerful to effect the necessary changes alone—that private leadership seeking to make changes must be given Government help and protection.

Since the war the interest of the public at large in the ownership of corporate enterprise has grown bigger, the size of the corporate unit has increased, the diffusion of corporate ownership has widened, all correlatively. Not only is nearly one half of the entire national wealth of the country represented by corporate stocks and corporate and Government bonds, but nearly one half of that corporate wealth is vested in the 200 largest nonbanking corporations which, piercing the thin veil of the holding company and disregarding a relatively few notable exceptions, are owned in each case by thousands of investors and are controlled by those owning only a very small proportion of the corporate stock. Ownership and control are in most cases largely divorced. It is estimated that more than 10,000,000 individual men and women in the United States are the direct possessors of stocks and bonds; that over one fifth of all the corporate stock outstanding in the country is held by individuals with net incomes of less than $5,000 a year. Over 15,000,000 individuals hold

insurance policies, the value of which is dependent upon the security holdings of insurance companies. Over 13,000,000 men and women have savings accounts in mutual savings banks and at least 25,000,000 have deposits in national and State banks and trust companies—which are in turn large holders of corporate stocks and bonds.

With this growth in security ownership by the public, the security markets have grown proportionately in importance. Two hundred and thirty-seven million corporate shares were sold on the New York Stock Exchange in 1923; despite the depression 654,000,000 shares were sold in 1933.

With such concentration of national wealth in the form of liquid corporate securities the economic machinery of the whole country is now affected by, and is organized primarily to serve, security markets which are as sensitive as a hair trigger. A magnificently organized lending machinery which operates by wire, can, with an offer of call-loan safety and 1 percent higher interest, draw funds from local banks which would otherwise seek moderate investment in local business enterprise, to finance the pool of a far-away metropolitan speculator distributing through the stock exchanges the securities of a huge corporate merger designed ultimately to swallow and destroy local enterprise. And there is a demonstrable direct relationship between easy credit for the purchase of new securities in the stock market and the trend toward industrial monopolies so accentuated since the war.

A rise in the security markets stimulates economic activity in all lines of business, a fall in the market precipitates a decline. If the rise in the market is occasioned by an excessive use of credit, a decline in the market loosens a process of deflation which feeds on itself and ruins not only security prices but all business as well. Between 1922 and 1929 brokers' loans increased from 1½ billion dollars to 8½ billion dollars. Five billion dollars of this increase took place in 3 years, 1½ billion dollars in the last 3 months. In the crash of 1929 the same loans declined 3 billion dollars in the first 10 days and 8 billion dollars in the next 3 years. These figures alone will enable the economic historian of the future to describe the unhealthy prosperity of 1929 and the inevitable grief and suffering that followed in the succeeding years—grief and suffering that overwhelmed and carried away not merely the speculative gains of those who participated in the speculative debauch, not merely the savings of the most frugal and most thrifty invested in securities, but eventually the operating profits of every business in the country no matter how unrelated to stock exchanges.

All through these years the machinery of the stock exchanges and of corporate management have only grown bigger without growing different. But this significant growth in size and importance of the exchanges and the business they do with the public has necessitated a real difference in kind in the treatment of that public by the law and by business ethics. Stock exchanges which handle the distribution and trading of a very substantial part of the entire national wealth and which have developed a technique of sucking funds from every corner of the country cannot operate under the same traditions and practices as pre-war stock exchanges which handled substantially only the transactions of professional investors and speculators. And standards of corporate management adequate to inspire investor confidence in the "caveat stockholder" era of closely held stock-

holder-managed companies cannot be stably perpetuated in an era where one company boasts over 700,000 stockholders, and 200 corporations control one half the corporate wealth of the country.

If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

When corporations were small, when their managers were intimately acquainted with their owners and when the interests of management and ownership were substantially identical, conditions did not require the regulation of security markers. Even those who in former days managed great corporations were by reason of their personal contacts with their shareholders constantly aware of their responsibilities. But as management became divorced from ownership and came under the control of banking groups, men forgot that they were dealing with the savings of men and the making of profits became an impersonal thing. When men do not know the victims of their aggression they are not always conscious of their wrongs. President Wilson showed a keen prophetic sense when he stated:

> Society cannot afford to have individuals wield the power of thousands without personal responsibility. It cannot afford to let its strongest men be the only men who are inaccessible to the law. Modern democratic society, in particular, cannot afford to constitute its economic undertakings upon the monarchial or aristrocratic principle and adopt the fiction that the kings and great men thus set up can do no wrong which will make them personally amenable to the law which restrains smaller men; that their kingdom, not themselves, must suffer for their blindness, their follies, and their transgressions of right.

II. General Analysis of the Bill

ITS SCOPE AND CONSTITUTIONALITY

The causes of dangerous speculation in the securities markets go far deeper than defects and abuses in stock-exchange machinery alone. They include inadequate central control of a national credit system that too easily provides for speculation funds which the national welfare much more requires in local commerce, industry, and agriculture. They include inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment of the values of securities a public continually solicited to buy such securities by the sheer advertising value of listing. They include exploitation of that ignorance by self-perpetuating managements in possession of inside

information. Speculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web. No one of these evils can be isolated for cure of itself alone. A stock-market pool, for instance, is only an effect and not a cause; the manipulator, a shell-game artist who can live only by following the county fair of too easy credit and ignorance.

A bill seeking effectively to control and regulate the securities markets therefore necessarily covers a wide field—necessarily touches more than a few willful speculators of Wall Street, necessarily calls for the cooperation of the widespread economic interests which the securities market affects. Business which was engulfed and nearly destroyed by the speculations of 1929 has its contribution to make in the form of fair and informing reports. Banks whose assets were carried away in loans based upon values inflated by reckless speculation must cooperate in permitting coordinated control of the delicate credit system which has been left to their management despite the fact that the Nation has had to expend billions of dollars to insure their solvency.

The factual situation which makes the legislation necessary is set forth in section 2. These recitals of fact: the use of the security markets as interstate markets in which ownership passes from residents of one State to those of another; the constant use of the postal facilities for the conduct of these markets; the abundant use of the credit facilities of national banks and of member banks of the Federal Reserve System; the effect of security prices upon transactions in interstate commerce, upon bank loans, upon taxes and upon credit available for trade, transportation, and industry—are common knowledge not only among economists but among bankers and business men everywhere. This legislation is not an attempt to reach out and correct the morals of the citizens of any one State; it is an attempt to deal with very vital economic problems going to the root of the functioning of our national credit system.

The constitutional significance of the wide delegation of powers to the Federal Reserve Board and to the Federal Trade Commission, which would administer the act, has been considered with particular care—and the delegation made only with the indication of such maximum standards for discretion as, in the considered judgment of the Committee, the technical character of the problems to be dealt with would permit. The bill legislates specifically just as far as the Committee feels it can. The original bill submitted to the Committee dealt very specifically and definitely with a number of admitted abuses. In many cases, however, the argument was made that while the solutions offered might be correct, their effects were so far-reaching as to make it inadvisable to put these solutions in the form of statutory enactments that could not be changed in case of need without Congressional action. Representatives of the stock exchanges constantly urged a greater degree of flexibility in the statute and insisted that the complicated nature of the problems justified leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case. It is for that reason that the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive rules and regulations, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced. In a

field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the administrative agency have been found practically essential, despite the desire of the Committee to limit the discretion of the administrative agencies so far as compatible with workable legislation. It has been represented that the pleas of the representatives of the stock exchanges for the vesting of broad discretionary powers in the administrative agencies have been made with a view to subjecting the bill to constitutional attack at a later date. The Committee has, however, taken the pleas in good faith believing that the nature of the legislation is such as to justify within constitutional limitations that measure of flexibility required in dealing with so intricate a subject matter.

ORGANIZATION OF BILL

The chief provisions of the bill may be grouped under six headings: (*a*) control of credits; (*b*) control of manipulative practices; (*c*) provision of adequate and honest reports to securities holders by registered corporations; (*d*) control of unfair practices of corporate insiders; (*e*) control of exchanges and over-the-counter markets; (*f*) administration.

CONTROL OF CREDITS

The underlying theory of the bill with respect to control of credit is as follows:

(1) Without adequate control the too strong attraction of a speculative stock market for credit prevents a balanced utilization of the Nation's credit resources in commerce, industry, and agriculture;

(2) To effect such better balance, all speculative credit should be subjected to the central control of the Federal Reserve Board as the most experienced and best equipped credit agency of the Government.

(3) To achieve that control the Federal Reserve Board should be vested with the most effectual and direct power over speculative credit, i.e., the power to control margins on the actual ultimate speculative loans themselves.

(4) Both for the direction and the protection of the Federal Reserve Board in the administration of flexible powers, Congress should offer the Board some definite margin standard to indicate the judgment of Congress that the amount of credit previously routed through the stock markets has been excessive and to indicate the approximate proportion in which such amount should be reduced.

To accomplish these purposes, sections 6 and 7 of the bill gives the Federal Reserve Board power to control speculative credit. The problem of control has been approached from several directions because of the certainty that no purpose of the bill will be more tempting to evasion. Borrowings by brokers to finance their customers are confined to borrowings from or through member banks of the Federal Reserve System or those nonmember banks which apply for a license from the Board. With respect to loans to the ultimate speculating customer, the Board is substantially given power by rules and regulations to fix margins on (*a*) all loans on securities from brokers to customers, and (*b*) loans from banks and others to customers made on equity securities and to carry or purchase securities. For the

purposes of guiding and protecting the Board from undue speculative pressure in the exercise of its discretion, the bill includes as a standard for the rules and regulations of the Board a limitation of credit on the initial granting of loans to 55 percent of the current market price of the securities offered as collateral, or 100 percent of the lowest market price of the preceding 3 years, whichever is the greater.

To avoid any conceivable deflationary effects upon presently existing loans on securities, all such loans, and renewals and extensions thereof, are exempt from the application of section 6 until January 1, 1939.

The main purpose of these margin provisions in section 6 is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.

The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market. Increasing margins—i.e., decreasing the amounts which brokers or banks may lend for the speculative purchase and carrying of stocks—is the most direct and the most effective method of discouraging an abnormal attraction of funds into the stock market.

When margins are discussed with this main purpose in mind differences between the collateral value of gilt-edged bonds and speculative stocks, the credit-worthiness of particular borrowers and similar considerations which have been urged as reasons why each loan should be treated as a particular problem in itself—considerations which affect not a general national credit policy, but only the safety of a particular stock transaction from the standpoint of a particular lender and particular borrower—are unimportant.

Section 6 empowers the Federal Reserve Board to prescribe margins for both brokers and banks on securities registered on exchanges licensed under the bill (hereinafter referred to as registered securities)—both for the initial opening and for the maintenance or carrying of accounts. The Board is given complete legal authority to fix margins at any point. But a standard is included in the bill as an indication by Congress to the Board that from the standpoint of a general policy of utilization of national credit resources, the Board should control the credit available to the stock market to an amount roughly corresponding to such standard.

To protect margin requirements from evasion brokers may lend only on listed securities excepting exempted securities. Banks are subject to margin limitations only on loans on registered equity securities in cases where the loan is sought for the purpose of purchasing or carrying securities. The Board is not required to fix the same margins for banks as for brokers and is given a free hand in fixing margins for maintenance as distinguished from margins for the initial opening of accounts.

It has seemed necessary to empower the Board to fix margins for banks as well as for brokers (*a*) to prevent evasion of restrictions on brokers' margins through loans by banks; (*b*) to increase the powers of the Board over speculative loans by its member banks; and (*c*) to give the Board an effective power (it has no powers at present) over speculative loans by nonmember banks.

The margin standard in Section 6 has been expressed as a percentage of market value which may be lent upon securities rather than of the amount which the customer is required to deposit at the time of his purchase. The basic loan value provided by the standard for the initial opening of an account is 55 percent of market value of the securities lent upon, i.e., from the standpoint of what the customer must "put up", a 45-percent margin. This standard is not indicated for the purposes of maintenance of the account. The 55-percent loan value indicated would govern in the long run of a rising market. But to afford easier margins for the present market and for a possible future declining market a more favorable alternative standard is indicated in Section 6 (*a*) (2), which, by the finding of Standard Statistics Service, would operate to permit, at the present time, an average initial loan value of 65½ percent of market value on the stocks now listed on the New York Stock Exchange, or, from the customer's point of view, a margin of only 34½ percent.

Under this alternative standard, the margin is only 25 percent in the case of a security that is selling at not more than 33⅓ percent above its 3-year low. As the security increases in price the margin required gradually increases proportionately until, when the security has reached a price that is more than 80 percent above its 3-year low, a margin of 45 percent is required. This flexible margin standard permits a relatively low margin in the case of stable securities such as bonds, while it requires a higher margin in the case of volatile securities after they have risen substantially in market price. Since the margin increases as the price of the security rises, pyramiding on paper profits is made difficult.

Section 6 seems to furnish a very practical program of controlling the volume of stock-market credit, since it embodies a combination of a basic formula, initially setting minimum margins, with a more general discretionary administrative control, which should be based on the total amount of credit outstanding, the level of stock prices, the phase of the business and financial cycle, and so forth. Between the time when changes are made by the Federal Reserve Board, margin requirements would be automatically raised or lowered by the movements of stock prices. Such a self-adjusting mechanism would probably function better, in actual practice, than any system wherein margin requirements are changed only by deliberate action of the Board and remain unadjusted except when the Board takes such action.

The 55-percent standard expressed in the statute is, however, so deliberately over-lenient for the purpose of encouraging the markets at this particular point in the recovery program, that the Board in exercising its discretion would be expected to lower this 55-percent figure considerably after the market reaches more normal levels.

CONTROL OF MANIPULATIVE PRACTICES

To insure to the multitude of investors the maintenance of fair and honest markets, manipulative practices of all kinds on national exchanges are banned. The bill seeks to give to investors markets where prices may be established by the free and honest balancing of investment demand with investment supply. Investors are free to buy and sell virtually without restraint. But wash sales and matched orders and other devices designed to create a misleading appearance of activity with a view to enticing the unwary into the market on the hope of quick gains are definitely prohibited. False and misleading statements designed to induce investors to buy when they should sell and to sell when they should buy are also outlawed and penalized.

But the most subtle manipulating device employed in the security markets is not simply the crude form of a wash sale or a matched order. It is the conscious marking up of prices to make investors believe that there is a constantly increasing demand for stocks at higher prices, or the conscious marking down of stocks to make investors believe that an increasing number of investors are selling as prices recede. Legitimate investors desire to buy at as low a price as possible and to sell at as high a price as possible, and honest markets are made by the balancing of investment demand and investment supply.

The provisions concerning manipulative practices have been drawn in light of the results of the recent investigation conducted by the Senate Committee on Banking and Currency. Despite all the talk of good pools and bad pools, no evidence has been submitted to this Committee that would justify the recognition of a good stock-market pool. As the Twentieth Century Fund in its recent report on "Stock-Market Control" states—

> As a matter of fact, any pool which seeks to bring about a change in the price of a security through manipulation is "illegitimate" according to our definition, inasmuch as it thereby lessens the efficiency of an exchange in the performance of those functions which, as we indicated, are the only justification for its existence.

If the pool to "rig" or "jiggle" the market is wrong, it necessarily follows that the market must be purged of reports about activities for the "rise" or operations for the "decline." If brokers and other interested persons are permitted to spread through brokerage and publicity channels constant reports regarding such activities, it is doubtful whether stimulated activity would not accomplish much the same effect as is accomplished by the direct mark-up or mark-down prices by the pool. For that reason the circulation of reports of market operations conducted for a rise or for a decline is prohibited.

The evidence as to the value of pegging and stabilizing operations, particularly in relation to new issues, is far from conclusive. While abuses are undoubtedly associated with such manipulation, because of the desire of the Committee to proceed cautiously such operations have not been forbidden altogether, but have been subjected to such control as the administrative commission may find necessary in the public interest or for the protection of investors.

The granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations, because the

granting of these options permits large-scale manipulations to be conducted with a minimum of financial risk to the manipulators. The bill, therefore, gives the administrative commission power to regulate dealing in options or trading in options. The connection of pool activity with the option has recently been recognized in the rules of the New York Stock Exchange. As it is not always easy to trace and prove manipulative activity, it is necessary to rid the market of devices which commonly accompany or cloak these activities. Short selling and stop-loss orders, which have been the source of much abuse, are brought within the regulatory power of the administrative commission.

There is plenty of room for legitimate speculation in the balancing of investment demand and supply, in the shrewd prognostication of future trends and economic directions; but the accentuation of temporary fluctuations and the deliberate introduction of a mob psychology into the speculative markets by the fanfare of organized manipulation menace the true functioning of the exchanges, upon which the economic well-being of the whole country depends.

To make effective the prohibitions against manipulation civil redress is given to those able to prove actual damages from any of the prohibited practices.

PROVISION OF ADEQUATE AND HONEST REPORTS TO SECURITIES HOLDERS BY REGISTERED CORPORATIONS

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance

sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet.

The need of proper and adequate reporting as an adjunct of the proper functioning of the exchanges has been expressed by the realistic and responsible Executive Assistant of the Committee on Stock List of the New York Stock Exchange:

It has been said a hundred times that accounting is a matter of conventions, and it is questionable whether these conventions have kept pace with the changes in modern business conditions. As the art stands today, it appears to the business man to have evolved with primary emphasis upon two objects:

(a) To give to management that accurate information and aid which is essential to the successful conduct of a business, and (b) to give to actual and prospective creditors that accurate information essential to the determination of the volume of credit which may safely be extended and the conditions under which it may be allowed.

Under conditions of ownership where the number of partners or stockholders was small, where enterprises were largely managed by their owners, or by the personally chosen representatives of a few owners in close contact with the business, and where it was the custom to finance permanently but little beyond minimum needs and to borrow largely to meet peak needs, accounting adequately performing these two functions probably sufficiently served the needs of the then situation. In the meantime the widespread diffusion of corporate ownership, with which we are all familiar, has occurred. There are few large enterprises which have not taken on the corporate form and a large proportion of the total ownership is in the hands of millions of relatively small investors who have no direct contact with management and whose only knowledge of the company is derived from its financial reports. In recent years there has been a marked tendency to finance more or less permanently for peak requirements, becoming lenders of money at the time of minimum requirements, and so tending to lessen the aggregate volume of bank credit needed.

Because of these changes, coupled with a growing tendency toward extreme broadness and flexibility in the corporation laws of many States, the time appears to have arrived for some changes of emphasis as to the objects to be achieved by sound accounting practice. While there have been able efforts devoted toward this end, the result so far generally attained does not seem to me sufficient to meet the needs. The need of accurate information for the aid of management is still paramount; but, under conditions of today, the next object in order of importance has become "to give to stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments."

This is, of course, the object in which the stock exchange is particularly interested. The primary object of the exchange is to afford facilities for trading in securities under the safest and fairest conditions attainable. In order that parties may trade on even terms they should have, as far as is practicable, the same opportunities for knowledge in regard to the subject matter of the trade.

The exchange is interested in the accounts of companies as a source of reliable information for those who deal in stocks. It is not sufficient for the stock exchange that the accounts should be in conformity with law or even that they should be conservative; the stock exchange desires that they should be fully and fairly informative.

The president of the New York Stock Exchange has effectively answered those who contend that such publicity will give advantage to competitors:

The public, today, insists upon more complete and accurate financial statements from publicly owned companies and I am sure that the officials and directors of these corporations, realizing the reasonableness of this demand, will furnish investors with adequate information. There have not been many instances where the failure to give complete information was due to a desire on the part of directors or officers to secure unfair personal advantage. However, many company officials did not publish complete financial statements because they were afraid that the disclosure of too much information would put their companies at a disadvantage

in meeting competition, not only from other American corporations, but frequently from foreign companies engaged in the same line of business. This fear, though genuine, has in large measure proved to be unfounded.

The reporting provisions of the proposed legislation are a very modest beginning to afford that long-denied aid to the exchanges in the way of securing proper information for the investor. The provisions carefully guard against the disclosure of trade secrets or processes. But the idea that a fair report of corporate assets and profits give unfair advantage to competitors is no longer seriously entertained by any modern business man. The realistic corporate executive knows that his alert competitors have a pretty good notion of what his business is and if he is unable to compete with them it is because he is hopelessly behind in the keen competitive struggle. The reporting provisions of the legislation have been approved by such conservative investment services as Moody's and Standard Statistics and, despite the wild fears spread throughout the country by powerful lobbyists against this bill, intelligent business men recognize that general knowledge of business facts will only help and cannot hurt them. The possession of these facts has for a number of years been the exclusive perquisite of powerful banking and industrial groups. Making these facts generally available will be of material benefit and guidance to business as a whole.

CONTROL OF UNFAIR PRACTICES BY CORPORATE INSIDERS

A renewal of investors' confidence in the exchange markets can be effected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage. Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity. For that reason, this bill requires the disclosure of the corporate holdings of officers and directors and stockholders owning more than 5 percent of any class of stock, and prompt disclosure of any changes that occur in their corporate holdings. Short selling and selling against the box by insiders are prohibited. These provisions have been called the "anti-Wiggin provisions" of the bill. The Committee is aware that these requirements are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage. It is hoped, however, that the publicity features of the bill will tend to bring these practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges.

Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the manage-

ment policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights. Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage. For this reason the proposed bill gives the Federal Trade Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders.

CONTROL OF THE EXCHANGES AND OVER-THE-COUNTER MARKETS

The importance of the actual workings of the exchanges themselves, although great, should not be exaggerated. The stronger and more subtle economic forces affecting speculation come from without the exchanges. But as this speculation converges upon the exchanges, the control of the exchange mechanism is a necessary part of any effective regulation. It is for that reason that the bill gives the Federal Trade Commission broad powers over the exchanges to insure their efficient and honest functioning. Theoretically floor trading has been assumed to be of value in stabilizing prices and preventing undue fluctuations. The studies conducted by the special counsel for the Senate Committee on Banking and Currency have thrown considerable doubt upon the value of floor trading. The large floor traders seldom stem the tide but run with it. Their activity tends to accentuate the moves of the market and to stimulate undue speculation. The importance of active, constant trading can readily be exaggerated. A relatively stable market over a period is of much greater importance to investors than a fictitiously stable market that involves no more than one eighth of a point spread between sales but results in wide fluctuations over days or weeks. The market's liquidity depends upon its relative stability and not upon the spreads between momentary sales. To prevent the artificial stimulation of the market that comes from excessive speculative trading unrelated to investment, the Commission is given power to regulate and, if need be, prevent floor trading. The Commission is further given power to prevent excessive trading by members off the floor who at times are tempted to stimulate the market by numerous in and out transactions which cost them nothing more than the nominal commissions paid to the $2 brokers.

No issue has been more disputed than that centering about the functions of the specialist. There are many who believe that the exchange mechanism would function better without the specialist, that the work done by the specialist could be done more effectively by a clerk or official of the exchange clearing the orders in a purely mechanical way, much as they are cleared today on the New York Stock Exchange in the "bond crowd." There are others who believe that a specialist should be obliged to act either as a dealer or as a broker and should not be permitted to combine the functions of dealer and broker. The jobber on the London Stock Exchange is essentially a

dealer-specialist who deals only with other jobbers and with brokers, and does not act as a broker himself or deal with the public directly. It is generally admitted that there are serious abuses in connection with the work of specialists. The New York Stock Exchange tightened its rules in regard to specialists on the very eve of the hearings held by the Committee. It is true that some of the worst evils associated with the specialist have centered around their participation in pools, but there are inherent difficulties in the situation where under normal circumstances the available orders are known to the specialist only—and perhaps his favored friends—and not to everyone dealing in the security involved. Inasmuch as the stock exchanges objected to the laying down of any statutory rule governing specialists, their suggestion has been adopted of giving the Commission effective power to control the activities of specialists and to experiment with various devices of control.

Another perplexing problem in regard to the working of the exchanges has been that centering about the dealer-broker relationship. There is an inherent inconsistency in a man's acting both as a broker and a dealer. It is difficult to serve two masters. And it is particularly difficult to give impartial advice to a client if the dealer-broker has his own securities to sell, particularly when they are new securities for which there is no ready market. The combination of the functions of dealer and broker has persisted over a long period of time in American investment banking and it was found difficult to break up this relationship at a time when the dealer business was in the doldrums and when it was feared that the bulk of the dealer-brokers would, if compelled to choose, give up their dealer business and leave, temporarily at least, an impaired mechanism for the distribution of new securities. Consequently it was deemed impracticable at this time to do more than require the dealer-broker to disclose to his customer the capacity in which he was acting and to refrain from taking into margin accounts new securities in the distribution of which he had participated during the preceding 6 months.

The bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interests of their members. The great exchanges of this country upon which millions of dollars of securities are sold are affected with a public interest in the same degree as any other great utility. The Commission is empowered, if the rules of the exchange in any important matter are not appropriate for the protection of investors or appropriate to insure fair dealing, to order such changes in the rules after due notice and hearings as it may deem necessary. The exchanges may alter their rules if more effective means are discovered to meet the same or new problems. Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped that the effect of the bill will be to give to the well-managed exchanges that power necessary to enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise.

The committee has been convinced that effective regulation of the exchanges requires as a corollary a measure of control over the over-

the-counter markets. The problem is clearly put in the recent report of the Twentieth Century Fund on "Stock Market Control":

> The benefits that would accrue as the result of raising the standards of security exchanges might be nullified if the over-the-counter markets were left unregulated and uncontrolled. They are of vast proportions and they would serve as a refuge for any business that might seek to escape the discipline of the exchanges; and the more exacting that discipline, the greater the temptation to escape from it. Over-the-counter markets offer facilities that are useful under certain conditions, but they should not be permitted to expand beyond their proper sphere and compete with the exchanges for business that, from the point of view of public interest, should be confined to the organized markets. This constitutes the sanction for Federal regulation of over-the-counter dealers and brokers. To leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges.

ADMINISTRATION

The bill places the administration of the legislation, apart from credit phases, in the Federal Trade Commission. It provides, however, for the enlargement of that Commission by two members and the creation within it of a special division which will administer both this bill and the Securities Act of 1933. Unquestionably these two measures are so closely related that they should be administered by the same body, and unquestionably if no new commission were to be appointed that administration should be lodged in the Federal Trade Commission, which has so ably organized the administration of the Securities Act of 1933.

Insofar as the proposals of the stock exchanges suggest a separate stock-exchange authority, it should be kept in mind that the name by which the body administering the act is known is not important. The legislative essentials are the same whether the body is called an authority or a board or a Federal commission. Those essentials are how much power the administrative body shall have and whether it shall be made up entirely of representatives of none but the public interest, or of "expert" representatives, as such, of stock exchanges and of other distinct classes in the community.

Insofar as "experts" are concerned, it is a commonplace of administrative statesmanship that boards of men who are experts in details rarely agree among themselves, and in their very expertness with the trees seldom perceive the woods of broad public policy. The well-learned lesson of democratic government with "experts" is that they should be kept on tap but not on top.

Insofar as making up a permanent Government regulatory body from representatives of special vested interests is concerned, it has been long ago learned that no harmony of policy can result from a regulatory body packed with advocates of warring interests, and that the inevitable result of placing on a regulatory authority able advocates who have at heart the definite interest of a particular class which will profit by the least possible regulation is stultification of the regulation

S. Rep. No. 1455, 73d Cong., 2d Sess. 1, 5, 36 (1934)

STOCK EXCHANGE PRACTICES

JUNE 6 (calendar day, JUNE 16), 1934—Ordered to be printed

Mr. FLETCHER, from the Committee on Banking and Currency, submitted the following

REPORT

[Pursuant to S.Res. 84, 72d Cong.; S.Res. 56 and S.Res. 97, 73d Cong.]

The Committee on Banking and Currency, authorized by Senate Resolutions 84, 239, and 371 of the Seventy-second Congress, and continued in effect by Senate Resolutions 56 and 97 of the Seventy-third Congress, to investigate security dealings, banking practices and effects of same, submits the accompanying introductory statement and report:

INTRODUCTORY STATEMENT

On March 2, 1932, the Senate Committee on Banking and Currency, or any duly authorized subcommittee thereof, was authorized and directed by Senate Resolution No. 84 of the Seventy-second Congress to make a thorough and complete investigation of the practices with respect to the buying and selling and the borrowing and lending of listed securities upon the various stock exchanges, the values of such securities, and the effect of such practices upon interstate and foreign commerce, upon the operation of the national banking system and the Federal Reserve System, and upon the market for securities of the United States Government, and the desirability of the exercise of the taxing power of the United States with respect to any such securities.

Pursuant to the resolution, an exhaustive investigation into stock-exchange practices was conducted by a duly authorized subcommittee of the Committee on Banking and Currency. Public hearings were held on April 11 and 12, 1932, with Claude Branch, Esq., acting as counsel to the subcommittee; and hearings were continued on April

CHAPTER I. SECURITIES EXCHANGE PRACTICES

1. Extent and Importance of Transactions on Exchanges

Transactions in securities on organized exchanges and over-the-counter markets are affected with a national public interest. Directly or indirectly the influence of such transactions permeates our national economy in all its phases. The business conducted on securities exchanges has attained such magnitude and has become so closely interwoven with the economic welfare of the country, that it has been deemed an appropriate subject of governmental regulation.[1]

In former years transactions in securities were carried on by a relatively small portion of the American people. During the last decade, however, due largely to development of the means of communication—the expanding network of telephone, telegraph, ticker, radio, and newspaper facilities—the entire Nation has become acutely sensitive to the activities on securities exchanges. While only a fraction of the multitude who now own securities can be regarded as actively trading on the exchanges, the operations of these few profoundly affect the holdings of all. Moreover, the currently realizable value of securities held by banks, trust companies, insurance companies, endowed institutions, and the like, is dependent upon market quotations and consequently the welfare of countless individuals who have a financial interest in such institutions is directly affected by activities on the exchanges.

Operations on organized exchanges have assumed extraordinary proportions. On 34 organized exchanges throughout the country, 1,525,018,217 shares were traded in during the year 1928, 1,849,454,014 during the year 1929, and 561,729,033 during the year 1932. As of July 31, 1933, there were listed on those exchanges 6,057 common and preferred stock issues with a total market value of $95,051,876,295; and 3,798 bond issues with a total market value of $49,080,819,993.[2]

It is evident that a business of such stature not only entails the use of the mails and other instrumentalities of interstate commerce, but itself constitutes an important part of the current of interstate commerce. Neither can it be doubted that the credit mechanism of the Nation is interlocked with transactions on exchanges, or that such transactions exert tremendous influence upon industry and trade. In retrospect, the fact emerges with increasing clarity that the excessive and unrestrained speculation which dominated the securities markets in recent years, has disrupted the flow of credit, dislocated industry and trade, impeded the flow of interstate commerce, and brought in its train social consequences inimical to the public welfare.

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[1] Securities Exchange Act of 1934, Securities Act of 1934, and Banking Act of 1933.
[2] Pt. 17, p. 7855, and New York Stock Exchange Year Book, 1932–33, pp. 117, 122.

Participation in a pool or its management by a broker is more than likely to entail a violation of that elementary fiduciary relation which he bears to his customers. By virtue of his connection with the pool, he has a personal pecuniary interest in the account and also incurs an obligation to his coparticipants to operate and manage the pool in a manner consonant with their best interests. Both his personal interest and his obligation to the other participants inevitably clash with the duty of unswerving loyalty and ungrudging disclosure which he owes to his customers. However honest his intentions, an interest in a pool prompts him to encourage his customers to purchase the securities which are the subject of the pool operations. It is difficult to perceive how he could act disinterestedly on behalf of a customer if such action would be inimical to the welfare of the pool. The conclusion is inescapable that members of the organized exchanges who had a participation in or managed pools, while simultaneously acting as brokers for the general public, were representing irreconcilable interests and attempting to discharge conflicting functions. Yet the stock exchange authorities could perceive nothing unethical in this situation.

(2) *The modus operandi of a pool.*—In connection with an ordinary pool operation, certain factors are usually considered advantageous to the pool operators: (i) A propitious time; (ii) the acquisition by the participants of a block of stock or an option to purchase a block; (iii) stimulation of activity in the stock by purchases and sales for the account of the pool; and (iv) the dissemination of information of a favorable character to encourage the purchase of the security by the general public.

(i) The propitious time to commence operations is when public attention has been attracted either by the condition of the corporation issuing the stock or the industry of which it is a part, or by external factual conditions, such as the possibility of legislation affecting the industry.

By way of illustration, such factors as the real or apparent prospect of a merger, a stock split up, a favorable earning statement, a resumption of or increase in dividends, an encouraging trade report, and the like, are useful in determining whether the time is ripe for a pool. In the case of the so-called " repeal " stocks, during the months of May, June, and July, 1933, the possibility of the repeal of the eighteenth amendment to the Constitution rendered the time propitious for the operation of pools in those stocks. A pool in Libbey-Owens-Ford Glass Co., which operated in June 1933, was materially aided by a popular delusion that the company was engaged in manufacturing glass bottles and was therefore classified as a repeal stock, whereas in fact it made no bottles and its business was in no way enhanced by the repeal of prohibition.

Mr. PECORA. Now, Mr. Day, let me ask you this: This stock, the Libbey-Owens-Ford Glass Co. stock, was commonly known as one of the " repeal stocks ", was it not?

Mr. DAY. By the average person who never took the trouble to look up what its business was.

Mr. PECORA. That is just what I am coming to. It was commonly known as a " repeal stock ", in the belief by those who regarded it as a repeal stock that the company did a kind of business that it was assumed would be made considerably more profitable through the repeal of the eighteenth amendment. Is not that so?

S. Rep. No. 792, 73d Cong., 2d Sess. 1-6 (1934)

FEDERAL SECURITIES EXCHANGE ACT OF 1934

APRIL 17 (calendar day, APRIL 20), 1934.—Ordered to be printed

Mr. FLETCHER, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany S. 3420]

The Committee on Banking and Currency, to whom was referred the bill (S. 3420) to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass. This bill is a substitute for the bill (S. 2693) introduced on February 9, 1934, and on which extensive hearings were held.

There follows a statement regarding the nature of the bill as reported, a general analysis thereof, and a summary of the bill by sections.

I. INTRODUCTORY STATEMENT

1. The President's Message

On February 9, 1934, the President sent the following message to Congress:

To the Congress:

In my message to you last March proposing legislation for Federal supervision of national traffic in investment securities I said, "This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges."

This Congress has performed a useful service in regulating the investment business on the part of financial houses and in protecting the investing public in its acquisition of securities.

There remains the fact, however, that outside the field of legitimate investment, naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pay envelop or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corpora-

tions with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in loss to the average investor, who is of necessity personally uninformed.

The exchanges in many parts of the country which deal in securities and commodities conduct, of course, a national business because their customers live in every part of the country. The managers of these exchanges have, it is true, often taken steps to correct certain obvious abuses. We must be certain that abuses are eliminated and to this end a broad policy of national regulation is required.

It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.

FRANKLIN D. ROOSEVELT.

THE WHITE HOUSE, *February 9, 1934.*

The foregoing message was supplemented by a letter from the President to the Chairman of the Committee on Banking and Currency under date of March 26, 1934. The President's letter is as follows:

Hon. DUNCAN U. FLETCHER,
Chairman Banking and Currency Committee,
United States Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: Before I leave Washington for a few days holiday, I want to write you about a matter which gives me some concern.

On February 9, 1934, I sent to the Congress a special messsage asking for Federal supervision of national traffic in securities.

It has come to my attention that a more definite and more highly organized drive is being made against effective legislation to this end than against any similar recommendation made by me during the past year. Letters and telegrams bearing all the earmarks of origin at some common source are pouring into the White House and the Congress.

The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929.

I have been definitely committed to definite regulation of exchanges which deal in securities and commodities. In my message I stated, "It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations."

I am certain that the country as a whole will not be satisfied with legislation unless such legislation has teeth in it. The two principal objectives are, as I see it—

First, the requirement of what is known as "margins" so high that speculation, even as it exists today, will of necessity be drastically curtailed; and

Second, that the Government be given such definite powers of supervision over exchanges that the Government itself will be able to correct abuses which may arise in the future.

We must, of course, prevent insofar as possible manipulation of prices to the detriment of actual investors, but at the same time we must eliminate unnecessary, unwise, and destructive speculation.

The bill, as shown to me this afternoon by you seems to meet the minimum requirements. I do not see how any of us could afford to have it weakened in any shape, manner, or form.

Very sincerely,

FRANKLIN D. ROOSEVELT.

2. The Necessity for Legislative Action

On March 2, 1932, Senate Resolution No. 84 was agreed to, authorizing the Committee on Banking and Currency (1) to make a thorough

and complete investigation of the practices with respect to the buying and selling and the borrowing and lending of listed securities upon the various stock exchanges, the value of these securities, and the effect of such practices upon interstate and foreign commerce, upon the operation of the national banking system and the Federal Reserve System, and upon the market for securities of the United States Government, and the desirability of the exercise of the taxing power of the United States with respect to any such securities, and (2) to report to the Senate as soon as practicable the results of such investigation and, if in its judgment such practices should be regulated, to submit with such report its recommendations for the necessary remedial legislation.

Pursuant to the resolution, an exhaustive investigation into stock exchange practices was conducted by the committee. Commencing on April 11, 1932, and at frequent intervals since that date, evidence gathered by its investigating staff has been presented to the committee at public hearings, which has laid the foundation for remedial legislation in a field heretofore unregulated.

The record compiled by the committee for the first time exposed methods by which a relatively small number of persons have extended their operations in securities far beyond any useful economic function, to the great detriment of the investing public. By the development of the margin account, a great many people have been induced to embark upon speculative ventures in which they were doomed to certain loss. The unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs, and the failure of corporations to publish full and fair reports of their financial conditions, have also been contributing causes of losses to investors.

Excessive speculation has caused acute suffering and demoralization. It has brought in its train social and economic evils which have affected the security and prosperity of the entire country. During the boom period a vast and unhealthy volume of credit was sucked into securities markets to the deprivation of agriculture, commerce, and industry, which made possible the inflation of prices of securities out of all proportion to their value. Feverish speculation accelerated the process of inflation until the bubble burst in October 1929. The market value of all stocks listed on the New York Stock Exchange slumped from $89,000,000,000 on September 1, 1929, to $15,000,000,000 on July 1, 1932. There can be little question that stock-market speculation is among the most potent of the factors which have contributed to the prolonged depression.

The evidence submitted to the committee by experts on the staff of the Federal Reserve Board has indicated that uncontrolled speculation on security markets was an important cause of the credit inflation which led to the collapse of 1929 and the subsequent depression. Banks diverted their credit from agriculture, commerce and industry to the stock market, where it contributed to the over-expansion of big enterprises, largely engaged in interstate commerce. Corporations took advantage of the abnormal demand for securities by raising new capital, which was not necessary for plant expansion, but which they loaned in the call-money market, thus encouraging further speculation. When the crash finally came, brokers' loans were called, causing greater depreciation in the value of securities, including those held in bank portfolios. This contributed largely

to the widespread bank failures, which imperiled the national banking structure. Foreign money had also been attracted to the call market, and was subjected to heavy withdrawals which contributed to the panic and the hoarding of gold associated with the dislocation of the national currency system.

That the country has learned little from the catastrophe of 1929 is evidenced by the speculative boom during the summer of 1933, which ended with the usual disastrous results to investors. If our present progress toward prosperity is not to be impeded from time to time by the financial collapse invariably following artificial inflation of security prices, it is essential that the Federal Government adopt measures which will enable it to stem the speculative tide whenever necessary.

3. Inadequacy of Self-Regulation of Exchanges

Stock exchanges have hitherto resisted proposals for their regulation by any governmental agency, on the ground that they are sufficiently able to regulate themselves to afford protection to investors. Especially during periods of popular agitation, or when legislative action has been threatened, the exchanges have taken steps to raise the standards for the conduct of business by their members and to require corporations to furnish more adequate information for the benefit of investors. Such attempts, however, far from precluding the necessity for legislative action, emphasize its need.

The contention of stock exchange authorities that internal regulation obviates the need for governmental control seems unsound for several reasons. In the first place, however zealously exchange authorities may supervise the business conduct of their members, the interests with which they are connected frequently conflict with the public interest. Secondly, the securities exchanges have broadened the scope of their activities to the point where they are no longer isolated institutions, but have become such an important element in the credit structure of the country that regulation, to be effective, must be integrated with the protection of our entire financial system and the national economy. Thirdly, the control exercised by stock exchange authorities is admittedly limited to their own members, and they are unable to cope with those practices of nonmembers which they deplore but cannot prevent. Fourthly, the attitude of exchange authorities toward the nature and scope of the regulation required appears to be sharply at variance with the modern conception of the extent to which the public welfare must be guarded in financial matters. Their adherence to the view that manipulation, pool activities, and the creation of illusory "price mirages" are proper and legitimate, except where certain technical violations of their rules are involved, is inconsistent with the type of regulation the public interest demands.

The manipulation of the so-called "repeal stocks" on the New York Stock Exchange during the summer of 1933 illustrates the ineffectiveness of self-regulation. On July 18, 1933, there was a violent fluctuation downward in security prices led by the repeal stocks. A few days later counsel for the committee requested the exchange to institute an inquiry for the purpose of ascertaining whether pool operations were being conducted in repeal stocks between May 15,

1933, and July 24, 1933. On October 16, 1933, a report was rendered by the New York Stock Exchange detailing the results of its examination made in connection with trading and operations in the securities of 6 companies. The report stated "that there were no material deliberate improprieties in connection with transactions in these securities" and that there was no evidence of "activities which might have stimulated improperly the activity of these stocks." Thereupon the committee caused an independent inquiry to be made by its investigating staff and a series of hearings were held before the committee at which the evidence collected was made public. The record of these hearings is replete with proof of manipulation of security prices, of pool operations in which corporate officials participated and profited, and of unsavory practices in connection with the listing of securities. The inability of the stock exchange authorities even to discover the flagrant abuses unearthed by the committee indicates that a Federal regulatory body could deal with such practices more effectively than the exchanges themselves.

Although the exchanges have endeavored to bring about an improvement in the type of financial reports filed by corporations, they have been hampered by the terms of the listing contracts made with issuers, which they have not considered themselves entitled to modify without the consent of such issuers. Progress in this direction has been further retarded by the unwillingness of issuers to furnish adequate information, supported by the threat of withdrawal of their listings, and by the potential competition of exchanges having more lenient standards. Such impediments could not exist so far as a Federal regulatory body is concerned. The present bill would effectuate a reform which the exchanges themselves have been advocating for many years. Hence their efforts to enlist the opposition of corporations to the proposed legislation is difficult to reconcile with their public utterances in the past.

The three principal problems with which the bill deals are the excessive use of credit for speculation, the unfair practices employed in speculation, and the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities.

II. General Analysis of the Bill

1. Enforcing Agency and Flexibility of Procedure

From the outset, the committee has proceeded on the theory that so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. Unless considerable latitude is allowed for the exercise of administrative discretion, it is impossible to avoid, on the one hand, unworkable "strait-jacket" regulation and, on the other, loopholes which may be penetrated by slight variations in the method of doing business. Accordingly it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion. Of course, well defined limits must be indicated within which the authority of such administrative authority may be exercised.

The committee considers that the act could be administered effectively by a Commission of five, to be appointed by the President with the advice and consent of the Senate, specifically for that purpose.

In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10, and 16. Moreover, the power to withdraw Federal registration is not a sufficient guarantee that the rules and regulations of the administrative authority, as well as the statutory provisions, will be observed; and accordingly the bill provides criminal penalties for violation of such rules and regulations. It is to be noted, however, that such penalties are limited to fines as distinguished from the penalties of imprisonment which may be inflicted for violation of the statutory provisions of the bill.

2. Registration of Exchanges

The bill forbids the use of the mails or instrumentalities of interstate commerce to any securities exchange which is not registered with the Commission as a "national securities exchange." The Commission, however, is empowered to exempt from registration small exchanges where the volume of transactions is not sufficient to invite the abuses prevalent on the larger markets. When applying for registration, exchanges must agree to comply with the act and with the rules and regulations of the Commission and to require observance of the same by their members.

In addition to the organized security markets, there exist in financial centers unorganized "over-the-counter" markets where securities are bought and sold in large volume. Many of these securities are of a conservative character, such as Government, State, and municipal bonds which are exempted from the provisions of the bill; but others are more speculative in nature and are subject to the abuses of manipulation. For example, the committee has heard evidence of extensive manipulation in certain New York bank stocks after their withdrawal from the New York Stock Exchange and while they were being sold "over the counter." These manipulations resulted in tremendous losses to the investing public, and in enormous profits to insiders. It has been deemed advisable to authorize the Commission to subject such activities to regulation similar to that prescribed for transactions on organized exchanges. This power is vitally necessary to forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on exchanges, and by transferring trading therein to "over-the-counter" markets where manipulative evils could continue to flourish, unchecked by any regulatory authority. Since the necessity for regulation of "over-the-counter" markets will depend largely on the extent to which activities prohibited on exchanges are transferred to such markets, provision for their regulation has been made as flexible as possible.

Article XIX, Sec. 1, of the Constitution of the New York Stock Exchange, Inc.

ARTICLE XIX

Special Trust Fund

¶ 1841 Terms and Conditions

SEC. 1. Those persons who at any given time are Directors of the Exchange shall be the Trustees of the trust known as the Special Trust Fund which was established by the Exchange by Deed of Trust dated July 30, 1964.

The principal of the trust shall consist of contributions made thereto by the Exchange as authorized from time to time by the Board of Directors, such principal and any net income accumulated thereon being hereinafter sometimes referred to as "the Fund."

The Fund shall, except as otherwise provided in this Section, be used solely for the purpose of providing direct or indirect assistance to customers of a member, member firm or member corporation threatened with loss of their money or securities because such member, member firm or member corporation, in the opinion of the Trustees of the Special Trust Fund, is insolvent or is in such financial condition that he or it may be unable without assistance to meet his or its obligations to such customers, but shall be used only to the extent, if any, and in the manner determined by the Trustees of the Special Trust Fund.

The Fund shall be kept separate and apart from any funds or other assets of the Exchange.

The net income realized on the Fund shall be added to and become a part of the Fund, except that whenever the net worth of the Fund is determined (as hereinafter provided) to be in excess of the sum of ten million dollars, the Trustees of the Special Trust Fund may apply the net income realized on the Fund in any calendar year thereafter, or so much thereof as they may determine, to the uses and purposes to which the Fund may be applied on termination of the Fund as hereinafter provided. The "net worth" of the Fund shall be determined by the Trustees of the Special Trust Fund and shall be that amount by which as of the close of the preceding calendar year, the total assets of the Fund (including cash, accounts receivable and investments stated at their market values but exclusive of accrued interest and accrued dividends) exceeded all its known liabilities.

Unless sooner terminated as hereinafter provided, the Special Trust Fund shall continue and may accumulate the income from the property held therein for such time as may be necessary to accomplish the purposes for which it is created. Upon termination, the Fund shall be transferred, conveyed, and paid over to such person, partnership, association or corporation, other than any member, member firm, member corporation or the Exchange, for such uses and purposes similar or related to the purposes for which the Fund was established, as the Trustees of the Special Trust Fund, in their sole and absolute discretion, shall determine, or, in the event the Trustees shall determine that no such similar or related purpose can be found, to such charitable uses and purposes as the Trustees, in their sole and absolute discretion, shall determine.

No member, member firm or member corporation, no customer of any such member, member firm or member corporation and no other person shall

in any event have any claim or right of action, at law or in equity, whether for an accounting or otherwise, against the Exchange, the Trustees of the Special Trust Fund, or any other person, or against the Fund, as a result of any action taken or the failure to act by the Trustees in the exercise of their discretion. Whether or not expenditures from the Fund shall be made in any particular case and, if so, in what manner, to whom and to what extent, shall at all times remain exclusively within the sole and absolute discretion of the Trustees of the Special Trust Fund.

The Special Trust Fund may be retained partly or wholly in the form of cash or may be invested and reinvested in such securities as the Trustees may from time to time deem appropriate, notwithstanding the provisions of any law governing the investment of trust funds by fiduciaries.

The Trustees of the Special Trust Fund may pledge any or all of the securities in the Fund to secure the repayment of any borrowing effected by the Trustees, the proceeds of which are to be used to provide direct or indirect assistance to customers.

Any action taken by a majority of the Trustees of the Special Trust Fund then in office shall constitute action on behalf of the Special Trust Fund.

The trust shall not be subject to amendment, modification or revocation in any manner which would permit the Special Trust Fund or the net income thereon to be applied to uses and purposes other than those set forth in this Section. The trust may otherwise be amended, modified or revoked by the Board of Directors acting pursuant to an amendment of this Article adopted in accordance with Article XX.

Amendments.
February 18, 1971.
Adopted March 1, 1972.

***Raldiris* v. *Simmons*, (S.Ct. N.Y.Co. 1932), *aff'd*, 42 App. Div. 603, 271 N.Y.S. 1018 (1st Dep't 1934), *aff'd*, 266 N.Y. 577, 195 N.E. 208 (1935)**

Summons. 7

SUPREME COURT,

NEW YORK COUNTY.

HARRIET J. RALDIRIS,

Plaintiff,

—against—

E. H. H. SIMMONS, as President of the New York Stock Exchange,

Defendant. 8

To the above named Defendant:

YOU ARE HEREBY SUMMONED to answer the complaint in this action, and to serve a copy of your answer, or, if the complaint is not served with this summons, to serve a notice of appearance, on the Plaintiff's Attorney within twenty days after the service of this summons, exclusive of the day of service. In case of your failure to appear or answer, judgment will be taken against you by default for the relief demanded in the complaint. 9

Dated, June 12th, 1928.

HULBERT & HEERMANCE,
Attorneys for Plaintiff,
Office and Post Office Address,
551 Fifth Avenue,
Borough of Manhattan,
City of New York.

10 **Amended Complaint.**

SUPREME COURT,

NEW YORK COUNTY.

[SAME TITLE.]

Plaintiff, for her amended complaint herein alleges:

FOR A FIRST CAUSE OF ACTION:

11 First: That the above named defendant, New York Stock Exchange, was at the times hereinafter mentioned and still is an unincorporated association consisting of more than seven persons, and at the time of the commencement of this action, the above named E. H. H. Simmons was the President thereof.

Second: That said New York Stock Exchange was formed for the purpose of furnishing an exchange room or rooms for the transaction of business by the members thereof, in the purchase and
12 sale of the shares of stock and other securities of various corporations incorporated under the Laws of the various states of the United States, and of foreign countries, which said Stocks, and securities are listed on the said New York Stock Exchange for customers of the various members of the New York Stock Exchange; and said New York Stock Exchange was at the times hereinafter mentioned and still is engaged in carrying out said purpose.

Third: That said New York Stock Exchange through its members had at the times hereinafter mentioned invited and still invites the public to

deal through the said members in the purchase 13
and sale of the said listed shares and securities, and has at the times hereinafter mentioned provided and still provides in its said exchange room or rooms special facilities and special places for the execution through its members of the orders of the public for the purchase and sale of said shares and securities; that at the times hereinafter mentioned the business of the purchase and sale of such shares and securities in the rooms of the said New York Stock Exchange had grown to very large proportions; that said New York Stock
Exchange had been for some time prior to the 14
time of the particular transactions hereinafter described and is now a national market for the purchase and sale of such shares and securities as said New York Stock Exchange sees fit to list, and the transactions upon said exchange establish and create the public market and largely influence the market price of such shares and securities to the public, so that said New York Stock Exchange had become at the times hereinafter mentioned, and is now, notwithstanding the fact that it is an unincorporated association, a business agency for its members conducting a business of a public
character for the profit and advantage of its mem- 15
bers.

Fourth: That it became and is the duty of the said New York Stock Exchange to the public to adopt and enforce rules and regulations for the protection of the said public in the latter's dealings with the various members of said New York Stock Exchange.

Fifth: Pursuant to said duty the said New York Stock Exchange did duly formulate and adopt certain articles of association and a certain

16 constitution and certain by-laws and certain other
numerous rules and regulations designed and intended to maintain high standards of commercial
honor and integrity among its members and to
promote and inculcate just and equitable principles of trade and business, and granting to various designated officers and committees the right,
and imposing upon them the duty to supervise the
conduct of the business of the Exchange and the
conduct of the transactions of its members, to
establish rules for the making of contracts and
performance thereof and governing defaults there-
17 under; and giving them the right, and imposing
upon them the duty to inquire into the business
conduct and financial condition of its members
and of the customers' accounts of its members and
to require of such of its members as carry margin
accounts the submission twice a year of a complete audit of their financial affairs, including an
audit of securities held by them; and giving them
the right, and imposing upon them the duty to
examine from time to time the books and papers
of its members and if any such member should
be found to have failed to meet his obligations or
to be insolvent, or to be in such financial condi-
18 tion as to make dealings with him unsafe, to suspend such member from the privileges of membership, and to announce such suspension to the public for the protection of the public.

Sixth: That the formulation and adoption of said articles of association and of said constitution and by-laws and of said rules and regulations were at all the times hereinafter mentioned, and are now, matters of public knowledge and knowledge thereof was disseminated among the public and communicated to the public, including

this plaintiff, by the said New York Stock Ex- 19
change, and such dissemination and such commu-
nication were carried out by said New York Stock
Exchange with the intent and for the purpose of
inducing the public to rely upon same, and upon
the proper enforcement of the same, and with the
intent and for the purpose of inducing the public
to purchase and sell through its members upon
the floor of the said New York Stock Exchange
the shares and securities listed thereon, and with
the intent and for the purpose of inducing the
public, including the plaintiff, to believe that the
business customarily carried on upon the floor of 20
the said New York Stock Exchange including
dealing in such shares and securities upon margin,
and including the deposit with the members of
said New York Stock Exchange of collateral in
various forms, might safely be carried on; and in
entering upon and carrying out the various trans-
actions with a certain member of the said New
York Stock Exchange hereinafter referred to, the
plaintiff did in fact rely upon the said articles and
the said constitution and the said by-laws and the
said rules and regulations and upon the proper en-
forcement thereof.

21

Seventh: That in or about the month of June,
1923, one Herman W. Booth, a member of the
said New York Stock Exchange, solicited the ac-
count of the plaintiff as a customer, representing
that he was a member of said New York Stock
Exchange in good standing, and that his transac-
tions were conducted in accordance with the rules
and regulations of said New York Stock Ex-
change; and plaintiff, relying, as aforesaid upon
the said articles, constitution, by-laws, rules, and
regulations, and upon the proper enforcement
thereof, deposited with the said Herman W. Booth

22 from time to time in connection with various dealings in the same upon the floor of the said New York Stock Exchange and for the purpose of safekeeping, and as collateral, various securities of the aggregate value of more than $800,000.00, such securities being more particularly the following:

	No. of Shares	Stock
	50	American Can Pfd.
	100	American Tobacco
	100	Atchison, Topeka & Santa Fe Railroad
	100	Atlantic Coast Line Railroad
23	50	Central Railroad of New Jersey
	180	Chase National Bank & Securities Corp.
	50	Chicago & Northwestern Railroad
	100	Delaware & Hudson Railroad
	100	Electric Bond & Share
	195	Equitable Trust Company
	400	General Electric
	200	General Electric Special
	50	Glen Alden Coal
	100	Missouri Pacific Railroad
	110	New York Central Railroad
	300	Norfolk & Western Railroad
24	350	Reading Co.
	100	Standard Oil of California
	2500	Standard Oil of New Jersey
	300	Southern Pacific Railroad
	400	Union Pacific Railroad
	50	U. S. Rubber 1st Pfd.
	400	Westinghouse Elec. & Mfg. Co.
	100	Pullman Co.

and said Herman W. Booth at the time of the filing of a petition in bankruptcy against him as hereinafter alleged, should have had on hand all of the foregoing securities.

Eighth: That the defendant, New York Stock 25
Exchange, carelessly and negligently and recklessly failed to observe and perform the provisions of its said articles of association and of its said constitution and of its said by-laws and of its said rules and regulations in that the defendant failed to examine the records and papers of the said Herman W. Booth, and failed to require the said Herman W. Booth to keep any books in which customers' accounts were recorded, although said defendant was informed, and well knew that said Herman W. Booth kept no books of account,
and failed to require the said Herman W. Booth 26
to furnish an audit of securities held by him as collateral, and for safe-keeping, and failed to make any examination of the securities turned over to the said Herman W. Booth by his customers, including the plaintiff, and failed to observe the transactions of the said Herman W. Booth on the floor of the Exchange, and failed to investigate his financial condition, and failed to discover the existence of conditions requiring the suspension of the said Herman W. Booth as a member of the Exchange and the announcement thereof to the public, and after learning that said Herman W.
Booth kept no records or books of any kind, 27
ordered the said Herman W. Booth to keep a set of books and then neglected and failed to require the said Herman W. Booth to comply with such order, and permitted him over a long period of time to continue as a member of the defendant, and permitted him to continue his transactions as such member upon the floor of the exchange, and permitted him for a long period of time to hold himself out to the public, including the plaintiff, as a member of the defendant in good standing and as a member whose transactions had been ex-

28 amined and investigated and approved by the defendant.

Ninth: That on or about the 27th day of September, 1927, an involuntary petition in bankruptcy was filed against said Herman W. Booth, as a result of which, on or about the 3rd day of October, 1927, said Herman W. Booth was duly adjudicated a bankrupt in the United States District Court for the Southern District of New York; and an examination of the assets of the said bankrupt disclosed the fact that none of the securities delivered to him by the plaintiff as aforesaid
29 were in his possession, but that, on the contrary, he had converted them to his own use, and the assets of the said bankrupt amounted to less than the sum of $275,000.00 as against liabilities of about $4,000,000.00.

Tenth: That the said negligence, carelessness and recklessness of the defendant, without any carelessness or negligence on the plaintiff's part contributing thereto, permitted the said Herman W. Booth to convert the plaintiff's securities as aforesaid, without discovery thereof, until after
30 the institution of said bankruptcy proceedings, and until after the said securities and the value thereof had been completely lost to this plaintiff; and a proper performance by the defendant of its aforesaid duty to the public, including the plaintiff, and a proper observance of the articles of association, by-laws, rules, and regulations of the defendant upon which the public, including the plaintiff, relied, would have rendered impossible the said conversion and the said loss.

Eleventh: By reason of the premises, the plaintiff has been damaged in the sum of $1,250,000.

FOR A SECOND CAUSE OF ACTION: 31

Twelfth: The plaintiff repeats and realleges each and every allegation contained in paragraphs numbered "First", "Second", "Third", "Fourth", "Fifth", "Sixth" and "Seventh" of this complaint, with the same force and effect as if they were here set forth in full.

PLAINTIFF FURTHER ALLEGES AS FOLLOWS, UPON INFORMATION AND BELIEF:

Thirteenth: That the defendant made the fol- 32
lowing representation: That no person is admitted to membership in the New York Stock Exchange unless and until such person's character, reputation and business and financial standing have been thoroughly investigated and found to be in all respects satisfactory.

Fourteenth: That the defendant made the following representation: The whole organization and plan of the New York Stock Exchange rests on the purpose of protecting the public; that the New York Stock Exchange at all times exercises
eternal vigilance to the end that each of its 33
several members shall rigidly adhere to the constitution, laws, rules and regulations of the New York Stock Exchange.

Fifteenth: That the defendant made the following representation: That no person is allowed or permitted to continue as a member of the New York Stock Exchange who is insolvent, or who refuses or fails to comply with its constitution, laws, rules and regulations.

Sixteenth: That the defendant made the following representation: That before admitting the

34 said Herman W. Booth to membership in the New York Stock Exchange, it thoroughly and carefully investigated the character, reputation and business and financial standing of the said Herman W. Booth, and declared him to be in all respects eligible to membership.

Seventeenth: That the defendant made the following representation: That every member of the New York Stock Exchange, including the aforesaid Herman W. Booth, is of the highest integrity and entitled to the trust and confidence of those persons desiring to purchase or sell securities
35 listed on said New York Stock Exchange.

Eighteenth: That the defendant made the following representation: That the New York Stock Exchange requires each of its members to keep and maintain a complete and accurate set of books showing in detail the transactions and dealings in securities carried on by each of said members, both in their dealings with each other and in their dealings with the public.

Nineteenth: That the defendant made the following representation: That periodically at stated
36 intervals the New York Stock Exchange examines the records and papers of each of its said members and requires each of its said members to furnish an audit of the securities held by said members, either as collateral or for safe-keeping.

Twentieth: That the defendant made the following representation: That the New York Stock Exchange carefully investigates the financial condition of each of its said members.

Twenty-first: That the defendant made the following representation: That the public, in-

cluding the plaintiff herein, might safely use the 37
said Herman W. Booth as broker in the purchase and/or sale of securities listed on said New York Stock Exchange, and in connection therewith might safely deposit with the said Booth money and/or securities necessary or proper in making such purchases and/or sales.

Twenty-second: That the defendant made the following representation: That the New York Stock Exchange does not and will not permit any of its said members to continue as a member in good standing if such member fails or refuses
to obey and comply with the laws, rules and 38
regulations of the New York Stock Exchange.

Twenty-third: That defendant's representation alleged in paragraph "Thirteenth" hereof was false, in that at the time the said Herman W. Booth was seeking to be admitted to membership in the defendant, said defendant failed and neglected to properly investigate into the reputation and business and financial standing of the said Herman W. Booth, but on the contrary admitted the said Herman W. Booth to membership when
he was at the time insolvent, and when the cost 39
or purchase price of his Stock Exchange "seat" was paid for with money borrowed by the said Herman W. Booth.

Twenty-fourth: That defendant's representation alleged in Paragraph "Fourteenth" hereof was false in that the defendant not only failed to exercise eternal vigilance, but failed to exercise even ordinary care in seeing that its members rigidly adhered to the laws, rules and regulations of the defendant, and especially in failing to exercise any care or vigilance whatsoever in seeing to

40 it that the said Herman W. Booth obeyed the constitution, laws, rules and regulations of the defendant.

Twenty-fifth: That defendant's representation alleged in Paragraph "Fifteenth" hereof was false, in that the defendant permitted the said Herman W. Booth to continue as a member of the defendant while insolvent; also in that defendant permitted the said Herman W. Booth to continue as a member of the defendant although the said Herman W. Booth refused or failed to comply with
41 the rules and regulations of the defendant.

Twenty-sixth: That defendant's representation alleged in Paragraph "Sixteenth" hereof is false in that the defendant failed and neglected to thoroughly and carefully investigate the character, reputation and business and financial standing of the said Herman W. Booth at the time the said Herman W. Booth applied to the defendant for admission to membership therein.

Twenty-seventh: That defendant's representation alleged in Paragraph "Seventeenth" hereof
42 was false in that the said Herman W. Booth was not and is not a person of the highest integrity, and entitled to the trust and confidence of persons desiring to purchase or sell securities listed on the said New York Stock Exchange, for the reason that said Herman W. Booth was guilty of numerous crimes for one or more of which he has been convicted and is now serving a sentence therefor in Sing Sing Prison.

Twenty-eighth: That defendant's representation alleged in Paragraph "Eighteenth" hereof was false in that the defendant did not require all of

its members to keep and maintain a complete and accurate set of books showing in detail the transactions and dealings in securities carried on by said members both with each other and with the public, and especially in that it failed, neglected and refused to require the said Herman W. Booth to keep such a set of books, although the said defendant had knowledge of the fact that the said Herman W. Booth was not in fact keeping any set of books; that when the defendant New York Stock Exchange discovered that the said Herman W. Booth was not keeping any set of books, he was specifically ordered to do so, but the defendant nevertheless failed and neglected to see that said order was obeyed. 43 44

Twenty-ninth: That defendant's representation alleged in Paragraph "Nineteenth" hereof, was false, in that the defendant failed and neglected to examine the records and papers of the said Herman W. Booth and failed and neglected to secure an audit of the securities held by the said Herman W. Booth as collateral and for safe-keeping.

Thirtieth: That defendant's representation alleged in Paragraph "Twentieth" hereof, was false, in that the defendant failed and neglected to investigate the financial condition of one of its said members, Herman W. Booth. 45

Thirty-first: That defendant's representation alleged in Paragraph "Twenty-first" hereof was false in that it was not safe for the public, including the plaintiff herein, to use the said Herman W. Booth as broker in the purchase and/or sale of securities listed on said New York Stock Exchange, nor to deposit with the said Booth money and/or securities necessary or proper in making such purchases and/or sales.

46 Thirty-second: That defendant's representation alleged in Paragraph "Twenty-Second" hereof, was false, in that the defendant permitted one of its said members, to wit: Herman W. Booth, to continue as a member in good standing, although the defendant well knew that the said Herman W. Booth had failed to comply with the rules and regulations of the defendant and that the said Herman W. Booth had failed and neglected to keep books of account as required by the rules of said defendant, and even after ordered so to do by the defendant, it neglected and failed to enforce
47 said order, and that the defendant well knew or should have known that the said Herman W. Booth was insolvent.

Thirty-third: Said representations referred to in Paragraphs "Thirteenth", "Fourteenth", "Fifteenth", "Sixteenth", "Seventeenth", "Eighteenth", "Nineteenth", "Twentieth", "Twenty-first" and "Twenty-Second" hereof and each of said representations, were false and fraudulent when made by the defendant, and were known by the defendant when made to be false and fraudulent or else were made by the defendant in reckless, wanton,
48 fraudulent and wilful disregard as to whether or not said representations of fact were true or false.

Thirty-fourth: The defendant intended that the plaintiff herein should rely upon the said representations in engaging the said Herman W. Booth as her broker for the purpose of buying and/or selling securities listed upon the said New York Stock Exchange and depositing with the said Herman W. Booth securities for safe-keeping.

Thirty-fifth: That the plaintiff, believing in the truth and accuracy of said representations of the

defendant and relying thereon, did deposit with 49
the said Herman W. Booth, a member of said defendant New York Stock Exchange, the securities more particularly described in Paragraph "Seventh" hereof, which is herein realleged and made a part hereof.

Thirty-sixth: Plaintiff repeats and realleges each and every allegation contained in the paragraph of the complaint herein numbered "Ninth".

Thirty-seventh: By reason of the false and fraudulent representations made by the defendant,
as aforesaid, plaintiff has suffered damage in the 50
sum of $1,250,000.

WHEREFORE, plaintiff demands judgment against the defendant in the sum of One million two hundred and fifty thousand ($1,250,000) Dollars, together with the costs and disbursements of this action.

HULBERT & HEERMANCE,
Attorneys for Plaintiff,
Office & P. O. Address,
551 Fifth Avenue, 51
Borough of Manhattan,
New York City.

(Verified August 7, 1931, by Murray Hulbert as Attorney for Plaintiff.)

190 New York, September 27th, 1932.

TRIAL RESUMED.

Mr. Uterhart: Before proceeding to take testimony in the case, I would like to make a motion to dismiss the first cause of action set forth in the amended complaint upon the ground that it does not contain facts sufficient to constitute a cause of action. It may seem somewhat premature, but I think the reason for the motion is so plain and so apparent, and I think the benefit of determining that question at this time is so great
191 in narrowing the issues in this case, that I press it seriously at this time. Now, the first cause of action sets forth the organization of the Stock Exchange; that it furnishes a board room for the sale of securities and various other activities on the Stock Exchange, and it then proceeds to plead the fact that Herman W. Booth was a member of the Stock Exchange, and that the Stock Exchange authorities in violation of their duty to this plaintiff failed to enforce the provisions of the constitution and by-laws of the Stock Exchange and failed to require Booth to
192 keep a proper set of books.

Now, the plaintiff in her complaint in the first cause of action pleads merely as a member of the public. She claims no privity of contract or other relations with the defendant Stock Exchange. Now, I think it is elementary that in order to hold one liable for an act of negligence there must be some relation of duty. The duty may arise by reason of the character of the place where a negligent act takes place, like a public street, but the same act in a public street will not render a defendant liable if done elsewhere. Take for example the case of a man target shoot-

ing or trap shooting on his own premises. If 193
some trespasser goes on the premises and stops a bullet that is intended for the target, the defendant is not liable, because his sole duty is to avoid doing wilfull harm to a trespasser. You see the act is not the whole question. It is also the relation of duty towards the plaintiff which determines the liability.

Now, this cause of action is a typical case of what is known as negligence in the air; that is to say where a member of the public comes forward and claims that by reason of the acts of the defendant, the defendant has made himself
liable for a negligent act. Now, that question of 194
course has just been passed on in the *Ultramares* case, and it was there determined that in order to render a defendant liable for such an act of negligence in the air, one of three things must happen: first, there must be some relation of duty created by a privity of contract; and then there were the other two exceptions, namely, where one sends out into the world a thing imminently dangerous to human life and a member of the public is injured, then the defendant may become liable. That was the *Buick* case that was decided some
years ago, and thirdly if there is a violation of 195
a statutory duty, the defendant may become liable to a member of the public. That was the well-known chicken feed case where the defendant sold chicken feed to the plaintiff through a public market and they found there was wire in it and the plaintiff's chickens were killed, and the ground of holding the defendant liable there was not an act of negligence but a violation of a statutory duty, namely the Pure Food Act. So the plaintiff brings herself within none of those categories, because there is no claim that there was any privity by contract or otherwise, between this plaintiff and

196 this defendant. And, as I say, in the *Ultramares* case, decided last year—your Honor is so familiar with the facts, it seems hardly necessary to review them,—but there the defendants were Touche, Niven & Company, public accountants.

The Court: I know that case very well.

Mr. Uterhart: And they were hired to make a balance sheet, and they knew the balance sheet was going to be used for the purpose of obtaining credit, and they negligently, under a state of facts which the Court of Appeals established was negligent,—certified that Stern Company had a million dollars worth of free assets, whereas in fact they
197 were insolvent, and it was held under those precise circumstances the defendant was not liable to the plaintiff under the theory of negligence, and it seems to me the plaintiff in this case has really recognized that for this reason, your Honor. This action was started in June, 1928, and the original complaint contained but one cause of action, and that based on negligence. After the decision in the Ultramares case, the plaintiff asked leave, and we consented, that they serve an amended complaint, and they then served an amended complaint setting forth a second cause of action in
198 fraud.

Now, it seems to me that this first cause of action is as dead as the fossils that Roy Chapman Andrews digs up in the plains of Asia. It is gone. And what is the use of having this fossil remain in this case. It is going to entail a great deal of unnecessary testimony which will subsequently have to be stricken out and I think the plaintiff herself realizes the inadequacy of this first cause of action, to establish her claim.

Mr. Hulbert: I do not know that it is necessary for me to make an extended reply to the

motion of Mr. Uterhart, because I anticipated 199
that in the memorandum which I submitted to your Honor yesterday, but I merely want to point out that there is a very substantial distinction in my opinion between the Ultramares case and the case at bar.

Incidentally, Mr. Untermyer argued the Ultramares case and he approved the original complaint in this action, and also the amended complaint, which was served upon his suggestion, because of the pronouncement of Mr. Justice Cardozo that gross negligence might amount to fraud.
200

In the Ultramares case there was no actual allegation of a relationship between the firm for whom the report was made by these accountants, and the people who would be expected to rely upon the certification of those accountants. But in this case we have a specific allegation here that the New York Stock Exchange was formed for a specific purpose, and then we proceed to allege that the New York Stock Exchange invites the public. Now, of course, the defendant in its answer denies that the New York Stock Exchange had any public duty, but I say to your
Honor in all frankness that the theory and the 201
essence of our allegation that they invite the public was this disposition upon the part of the Stock Exchange to play the old game of tweedle-dee and tweedle-dum, because when this legislation was before the Legislature for the purpose of attempting to put the Stock Exchange under the supervision of the Department of Banks, the President of the Stock Exchange and his counsel Mr. Milburn, attended there and protested upon the ground that the Legislature could not of itself place as great a responsibility upon the individual members of the Stock Exchange as the Stock

202 Exchange itself exerted in accordance with the provisions of its Constitution and its by-laws, and it was because of that assertion of public duty, which I will show in this case they have reiterated in litigations pending in these courts, our Supreme Court, that we made that allegation, and we are prepared to establish that there was a public relationship, and that the plaintiff in this case not only was cognizant of it, but dealt with respect to it, so that I am satisfied that the testimony in this case will convince your Honor, in line with the allegations that are in the com-
203 plaint for the purpose of making it relevant that we go far beyond the facts as they were adduced and as they appeared before the Court of Appeals when the decision was written in the Ultramares case and I don't feel that at this time it is incumbent upon me to enlarge upon this argument, because as I say, I set all those facts forth to your Honor in the memorandum I submitted yesterday, anticipating such a motion as has now been suggested.

The Court: I am bound, I think, to grant the counsel for the defendant's motion to dismiss the first cause of action. There isn't any question
204 about it.

Mr. Hulbert: May I note an exception?

E[illegible] J. Goodwin, residing at 8918 118th Street, Richmond Hill, Long Island, called as a witness in behalf of the plaintiff, being first duly sworn, testified as follows:

Direct examination by Mr. Hulbert:

Q. By whom are you employed, Mr. Goodwin? A. The Southern Pacific Company.

of prices as indicated on the respective dates 1399
"American Tobacco, October 8th, 1926, with range of prices on that date, 119⅛ — 120⅜. Those intended to cover the securities which the testimony here we claim has shown Mr. Booth represented at least he bought for Mrs. Raldiris.

Then the third subdivision of the stipulation is that the following corporations gave stockholders rights to subscribe to additional stock.' That has all been proven in the record. And then the fourth subdivision of the stipulation is that the highest prices at which the shares of stock listed below sold during each of the years inclusive were 1400
as follows: And then follows American Can 1923, 109⅜; 1924, 119; 1925, 121⅞; 1926, 130⅛; 1927, 141¾; and in the same way the highest sale price for each of those stocks was given for the years 1923, to 1927 inclusive, except that in the case of American Tobacco and Atchison, Topeka and Santa Fe, Atlantic Coast Line and other stocks that were not bought until later, the high prices do not begin until the year when those stocks were purchased, according to our claim.

This stipulation, of course, being in evidence, may be referred to by either counsel, and may
also be taken by the jury. 1401

The plaintiff rests.

Mr. Uterhart: Your Honor, I would like to be heard not at length, but shortly on a motion to dismiss the complaint and I take it your Honor will dismiss the jury.

The Court: Ask the jury to kindly step out. We will take a recess for five minutes.

(The jurors are excused during the course of the argument.)

Mr. Uterhart: If your Honor please, I move to strike out the minutes of the Legislative hearing contained in Plaintiff's Exhibit 92 for Identi-

1402 fication, the plaintiff having offered in evidence and read to the jury those portions which contained the arguments of Seymour Cromwell and John G. Milburn, upon the ground that they have not been connected with the plaintiff and there is no evidence showing that they ever came to the knowledge of the plaintiff.

I make a similar motion with respect to the brief which was submitted to the Legislative Committee on the same Lockwood bill, which was introduced in evidence as Plaintiff's Exhibit No. 93 upon the same grounds.

The Court: Motion denied.

1403 Mr. Uterhart: Exception.

I also move to strike out the newspaper statements containing the alleged reports of these speeches before the Legislative Committee.

The Court: Motion denied.

Mr. Uterhart: Exception. I also move to strike out Exhibits Nos. 123 to 166 inclusive, which are the various communications introduced in evidence from Booth to the plaintiff, upon the ground that they are mere hearsay statements and not binding on the defendant.

The Court: Motion denied.

1404 Mr. Uterhart: Exception.

The defendant moves to dismiss the second cause of action set forth in the amended complaint upon the ground that the plaintiff has failed to establish facts sufficient to constitute a cause of action, and, without limiting the general motion, upon the particular grounds also that there is no proof of any statement of fact made by the defendant to the plaintiff, there is no proof of the falsity of any statement of fact made by the defendant to the plaintiff; there is no proof of the defendant's scienter of such falsity, there is no proof of the plaintiff's reliance on any such state-

ments of fact, and there is no proof that the plaintiff suffered any damage as the result of any such statement, there is no sufficient proof of damages, and there is no sufficient proof of the conversion of plaintiff's securities; upon the further ground that any act of the defendant as shown here was not the cause of the plaintiff's loss, but it was Booth's intervening criminal act which caused the plaintiff's loss. 1405

Now, I would like to be heard briefly on that, if your Honor desires to hear me. Do you?

The Court: No. I will hear Mr. Hulbert.

Mr. Hulbert: Your Honor desires to hear me 1406
on the motion that Mr. Uterhart has made for a dismissal?

The Court: Yes.

Mr. Hulbert: Well, I think I can afford to be very brief, if the Court pleases, and I am reverting now to the 18th and 19th pages of the brief submitted by counsel for the defendant. I need hardly remind your Honor that I submitted a rather voluminous trial brief in this case in which I not only attempted, in my feeble way to go into an analysis of the Ultramares case and to show the distinction in the Ultramares case in the first
instance, so far as negligence is concerned, which 1407
has now gone out the window; but in view of the fact that the Ultramares case was sent back by the Court of Appeals for a retrial upon the question of fraud and because it seemed to me that to some extent at least the Chief Justice of the Court of Appeals went so far as to indicate to the trial court the leanings of the Court of Appeals on that question of fraud as distinguished from negligence in the air in the prevailing opinion, I went rather exhaustively into it, but I find reference in the brief of the defendant to the want of care falling short of fraud.

1408 Mr. Uterhart: Page what?

Mr. Hulbert: It is in pages 18 and 19: "In my opinion a false statement through want of care falls short of and is a very different thing from fraud and the same may be said of a false representation honestly believed though on insufficient grounds.

Mr. Uterhart: I have it.

Mr. Hulbert: And you go on there to quote the opinion of Judge Cardozo and the point that I desire to emphasize, and I think it is the crux, your Honor of this whole question. The defendant here of the honest belief absent. Well, if the
1409 honest belief was absent and the defendant shut its eyes to the facts, or purposely abstained from inquiring into them, then under that decision, the honest belief was absent and just as fraudulent as if the defendant had knowingly stated that which was false. In other words if the honest belief is absent, and it is absent—the honest belief is absent—then it is just as fraudulent as if the defendant had knowingly stated that which was false.

Now, what is the fact with respect to that? It seems to me it is one that must be left to and
1410 determined by the jury. To begin with, there is a representation here by the Stock Exchange with respect to the care with which they investigate an applicant for membership. Well, did the evidence that they submitted in this case show that there was a careful investigation with respect to Mr. Booth before he became a member of the Stock Exchange? That of course, is a question of fact. Then we have this representation made by Mr. Cromwell before the Legislature in 1923, that the concern—I do not know that I approximate the precise words—that the concern of the Stock

Exchange is to protect the public, and any attempt on the part of the Legislature to interfere with it, will not be lightly treated. Now, immediately following that, there was a change made in the form of the questionnaire. That was a matter of public record. Then we find that in December of 1924, it was reported to the Stock Exchange by one of their accountants with relation to the questionnaire that was submitted on the 31st of October, 1924, that they could not audit that. He said "We could not audit this thing because there were no books being kept." Well, they knew there were no books being kept. They had notice of it. What did they do? First of all they sent another man over there. That was Haveron, that was over there. They sent the chief accountant, Mr. Matthews. Mr. Matthews came back and said "Yes, it was true that they kept no books, but he only had one or two accounts." Why bless me, if they had gone over there and examined these check book stubs that we put in evidence this morning, they would have found out that this man had a great number of accounts. Well, they wrote him a letter and they told him that they were amazed to find that he was not keeping books. Mr. Blagden said it was unthinkable that a man should be permitted to do business that did not keep books. Well, the very regulations of the Stock Exchange themselves required that any man who was engaged in doing a margin business had to keep books, so that this man was absolutely and unqualifiedly violating the provisions of the constitution and the rules and regulations of the Stock Exchange and they knew it. They had it brought home to them. What did they do? They wrote him a letter and said they were amazed and that he must keep books, and he wrote back and he said he would. And then Mr. Simmons testi-

1411 1412 1413

1414 fied and counsel made the statement in his opening address to the jury, "why this man had been a member of the Stock Exchange for ten years. We had a right to rely upon his integrity as a member." And they made no investigation. They did nothing whatsoever. They simply took it for granted that because he said that he would keep books, that he was going to keep books. And here Mr. Simmons went on, the Committee of Publicity went on, and they made the declaration in that brown book that we call the history of the Exchange in which they said that based on an experience of over a hundred years they were tak-
1415 ing these various measures for the most rigid enforcement of their rules and again and again he speaks in these speeches that were put in evidence of the fact that the Stock Exchange will go furthere in the enforcement of those regulations in the protection of the public than any court of law would go, and here we have them stating in speech after speech that they do not want any regulation by the Legislature because this organization is better able to regulate itself than any Legislature is and they say in these statements that they have complete and autonomous control over the
1416 members of the Stock Exchange. Now, doesn't all that show the absence of an honest belief, when they are telling the public of the rigorous manner in which they are enforcing their regulations on the one hand, while on the other hand they know, they have it brought home to them that this man is not keeping books and they don't do anything more about it than write him a letter? And when the final blow-up comes in 1927, three years later, we find he has never kept any books. I say, your Honor, under the language of the authority that I have just referred to that there was an absence of honest belief, and that

the absence of honest belief, to quote the Court, 1417
is just as fraudulent as if he had knowingly stated that which was false, and if he had knowingly stated that which was false, there couldn't be any question in this case, but what the six elements of fraud are present and that in my humble opinion we are entitled to go to the jury.

The Court: Bring in the jury.

(The jurors return to the court room.)

The Court: The defendant's motion to dismiss the complaint is granted. The plaintiff has failed to make out a cause of action. Proof of the many elements of fraud is lacking in this case. There 1418
is nothing to be submitted to the jury.

Mr. Hulbert: Your Honor will allow me an exception?

The Court: Yes, sir.

Statement That Case Contains All the Evidence.

This case contains all the evidence had and adduced upon the trial of this action, as well as the exceptions of both sides. 1419

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

LLOYD E. WILSON and MAE WILSON, Plaintiffs, v. MEYERSON & CO., INC., a corporation; L. JACK BLOCK, EDWARD BURKE, D. RUSSEL BURWELL, VICTOR GRANT, HAROLD E. BAUMAN, MICHAEL E. SCHOP, HARRY MEYERSON, and DOES I through X, inclusive, RAY BURNE, as liquidators for MEYERSON & CO., NEW YORK STOCK EXCHANGE, INC., a New York corporation, Defendants.	Civ. 72-1298-OJC ORDER GRANTING DEFENDANT NEW YORK STOCK EXCHANGE'S MOTION FOR SUMMARY JUDGMENT

Plaintiffs, a married couple, brought this action for monetary damages, alleging numerous violations by defendants of the federal securities laws. Specifically, plaintiffs allege in their twelve-count First Amended Complaint violations by one or more of defendants of Sections 6 and 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78f & 78j(b)); Rule 10B-5 of the Rules and Regulations of the Securities Exchange Commission (17 C.F.R. 240.10B-5); and Sections 12(2) and 17 of the Securities Act of 1933 (15 U.S.C. §§ 771(2) and 77q). Only the tenth, eleventh and twelfth counts of the complaint apply to the defendant and moving party New York Stock Exchange (Exchange). Jurisdiction in this action is based on 15 U.S.C. §§ 77v and 78aa.

Plaintiffs, Dr. and Mrs. Wilson, entered into a subordinated loan agreement with defendant Meyerson & Co., Inc.

(Meyerson), dated November 30, 1969. Pursuant to this agreement, Dr. Wilson transferred securities valued at $211,643.00 to Meyerson, who was to pay the Wilsons four percent interest on this loan. Meyerson had the right to sell the securities in its trust, while the Wilsons retained the right to receive all dividends and interest payable by the issuer of the securities and to substitute other securities for those originally surrendered.

The Wilsons executed this agreement on the advice of defendant L. Jack Block, their personal broker. They apparently relied on Block's advice for most of their investment activities, including information respecting the theory and operation of a subordinated loan agreement. Block evidently assured plaintiffs not only that Meyerson was in "excellent financial condition," and that there would be "no risk" to their securities, but also that the New York Stock Exchange, of which Meyerson was a member, maintained a trust fund of $25 million as insurance to cover any losses that might be suffered by the Wilsons as a result of their agreement.

On January 29, 1970, the Exchange gave its approval to the agreement, even though it was known that Meyerson was under investigation by the Securities Exchange Commission and had been in violation of the Exchange's net capital rule prior to November, 1969.

During the winter and early spring of 1970 plaintiffs received repeated assurances from Block that despite Meyerson's apparent financial and legal difficulties, their securities were safe. Both plaintiffs indicated in depositions and affidavits that they trusted Block completely. On May 5, 1970, however, plaintiffs received a telegram from Meyerson notifying them that their securities were about to be sold and that if they desired to substitute securities, they should do so within twenty-four hours. On May 6, 1970, plaintiffs visited

Meyerson's office and did substitute securities. Meyerson's president informed them on either May 5 or May 6 that there was no insurance to cover any losses they might incur, contrary to the representations of Block. Although Block persisted in assuring plaintiffs otherwise, Dr. Wilson took the initiative on May 6 to contact his personal attorney and ask him to look into the matter. The attorney wrote to the Exchange and inquired into the matter of insurance. The Exchange replied on June 22, 1970, that in fact there was no such insurance. In August of 1970 plaintiffs learned that as a result of Meyerson's insolvency and liquidation, the entire value of their securities was lost.

Plaintiffs filed this action against all defendants except the Exchange on July 17, 1972. It was not until June 11, 1973, that plaintiffs filed their First Amended Complaint naming the Exchange as an additional defendant. On February 3, 1976, pursuant to plaintiffs' motion, the Court dismissed the action as to defendants Meyerson & Co., Harry Meyerson, Harold Bauman and Edward Burke.

Defendant New York Stock Exchange moves for summary judgment in its favor on a number of grounds. One of these grounds is that as to the Exchange the suit was barred by the applicable statute of limitations. "Motion for summary judgment is a proper method for testing whether the claim is barred by the statute of limitations." Turner v. Lundquist, 377 F.2d 44, 46 (9th Cir. 1967). Because the Court agrees that the statute of limitations did bar the action, the other grounds upon which the Exchange bases its motion will not be discussed.

As noted earlier, only the tenth, eleventh and twelfth counts of the complaint pertain to the defendant Exchange. In effect, the tenth count charges the Exchange with a violation of Section 6 of the Securities Exchange Act of 1934, in that the Exchange allegedly breached its "statutory duty ....

to adopt and enforce rules regulating the conduct of its member broker-dealer firms" (¶ 6 of tenth count). Since there is no federal statute of limitations applicable to Section 6 of the Securities Exchange Act, local law must be resorted to for a determination of the appropriate limitations period. Turner v. Lundquist, supra at 46, citing Errion v. Connell, 236 F.2d 447 (9th Cir. 1956). The Court agrees with plaintiffs and the Exchange that the local statute of limitations which governs the tenth count in this instance is Section 338, subdivision 1, of the California Code of Civil Procedure. That statute provides for a three-year period of limitations on bringing "[a]n action upon a liability created by statute, other than a penalty or forfeiture." The cause of action raised by Section 6 of the Exchange Act was unknown at common law; it is therefore squarely within the language of Section 338, subdivision 1.

Regarding this section, this Court has observed that "[i]t is well established that the statute begins to run at the time the plaintiff's interest is invaded." Levy v. Paramount Pictures, 104 F.Supp. 787, 789 (N.D. Cal. 1952), citing Suckow Borax Mines Consolidated v. Borax Consolidated, 185 F.2d 196 (9th Cir. 1950). The last possible day on which plaintiffs' interests could have been invaded in this case was May 6, 1970, when their securities were sold by defendant Meyerson & Co., resulting eventually in the loss that gave rise to this lawsuit. Since the charge leveled against the Exchange is a breach of its duty to enforce its own rules and regulations against Meyerson, one of its member firms, it is more likely that plaintiffs' interests were invaded, if at all, at some time prior to May 6, when Meyerson's financial troubles were already known to the Exchange. In any event, even if the correct date on which the statute began to run is May 6,

1970, plaintiffs did not file their action against the Exchange until June 11, 1973, more than three years later.

Plaintiffs argue that the statutes of limitations established under Section 338 of the Code of Civil Procedure do not begin to run until plaintiffs have knowledge of facts sufficient to put them on notice of their claim. They base this argument on the language found in subdivision 4 of Section 338, applicable in actions for relief from fraud or mistake:

> The cause of action in such case not to be deemed to have accrued until the discovery by the aggrieved party of the facts constituting the fraud or mistake.

This additional language is conspicuously absent from subdivision 1 of Section 338, however, and is therefore not applicable to the Section 6 violation alleged in the tenth count of the complaint, which is <u>not</u> an action for fraud but rather "an action upon a liability created by statute." The Section 6 cause of action thus accrued at the time plaintiffs' interests were invaded, which the Court has already established as no later than May 6, 1970.

The claims stated in the eleventh and twelfth counts of the complaint also run afoul of the applicable statute of limitations and must be dismissed. Plaintiffs concede that their claim in the twelfth count of a violation of Section 12(2) of the Securities Act of 1933 is barred by the running of the applicable one-year statute of limitations set forth in 15 U.S.C. § 77m.

The remaining allegations against the Exchange in the eleventh and twelfth counts, although arising under the federal securities laws, are in the nature of actions for fraud and as such are governed by the local three-year statute applicable to such actions, that is, subdivision 4 of Section 338 of the California Code of Civil Procedure. <u>See</u> <u>Turner</u>

v. Lundquist and Errion v. Connell, supra.

It is settled that with respect to actions for fraud the statute of limitations does not begin to run until the plaintiff "has knowledge of facts sufficient to make a reasonably prudent person suspicious of fraud, thus putting him on inquiry." Helfer v. Hubert, 208 Cal. App. 2d 22, 26 [24 Cal. Rptr. 900] (1962). See also United California Bank v. Salik, 481 F.2d 1012 (9th Cir. 1973); Turner v. Lundquist, supra. In this case the most telling evidence of plaintiffs' knowledge of facts that should have put them on inquiry is the affidavit of Dr. Wilson filed in opposition to the motion. Although both plaintiffs were aware prior to May 5, 1970, that Meyerson was being investigated by the SEC, they chose to rely on Block's assurances that there was nothing to worry about. The basis of their confidence apparently was their belief in the existence of the insurance fund. On May 5, 1970, however, they were informed by Meyerson's president that there was no such insurance. This revelation prompted Dr. Wilson once again to seek -- and obtain -- assurances from Block.

Despite Dr. Wilson's assertion in his affidavit that he "had no reason to doubt Block's word," his own actions attested to in the same affidavit belie this assertion. At page three of the affidavit Dr. Wilson states: "It was at that time that I decided to ask my personal attorney to check into this and he, James Lucey, wrote a letter to the New York Stock Exchange inquiring as to the insurance."

In depositions Dr. and Mrs. Wilson indicated that they were "shocked" upon being informed of Meyerson's financial troubles in the May 5, 1970, telegram; that this telegram alerted them to the possibility of a total loss of their securities; and that they were so surprised and concerned about the conflicting information as to the existence of

insurance that they were moved to contact their own attorney.

Where a plaintiff has first-hand knowledge of information evidencing a reasonable possibility of fraud, the statute of limitations begins to run. Von Brimer v. Whirlpool Corp., 367 F. Supp. 740, 746 (N.D. Cal. 1973). Actual discovery of the fraud need not be proved if the facts are such that a prudent person would have been suspicious and no reasonable countervailing inferences could be drawn from these facts. Helfer v. Hubert, supra at 26-27, 29. In this case, not only are the facts such that a prudent person would have been put on inquiry, but there is also the unassailable fact that plaintiffs did begin such inquiry by contacting their attorney.

Full knowledge of all the facts constituting fraud is not necessary to start the running of the statute. Where one has the means of knowledge, one is said to have the equivalent of knowledge and cannot remain supine and thereafter claim the statute was tolled until the possibility of fraud became a certainty. See Unique Balancing Co. v. DeVries, 166 F. Supp. 848, 850 (N.D. Cal. 1958); Helfer v. Hubert, supra. Nor may plaintiffs claim that unquestioned reliance on the averments of a fiduciary such as Block saves them from the running of the statute, where other facts giving rise to a reasonable suspicion were known to them. Hupp v. Gray, 500 F.2d 993, 997 (7th Cir. 1974). Even were such reliance sufficient, the facts indicate that it no longer persisted as of May 6, 1970.

It is the opinion of this Court, then, that as to defendant New York Stock Exchange the three-year period of limitations for fraud as specified in the statute applicable to plaintiffs' claims under Rule 10B-5, Section 10(b) of the Securities Exchange Act, and Section 17 of the Securities Act began to run no later than May 6, 1970, when plaintiffs commenced

their inquiry into the possibility of a loss of their securities. Since plaintiffs did not file their action against the Exchange until June 11, 1973, more than three years later, it is time-barred and the Exchange is entitled to judgment as a matter of law.

The Court recognizes that by applying the statutes of limitations here it effects a harsh result. Nevertheless, these statutes have a purpose and cannot be ignored, especially where, as here, plaintiffs managed to file their action against all other defendants well within the period of limitations.

Accordingly, the applicable statutes of limitations having been found by the Court to bar all of plaintiffs' claims against the defendant New York Stock Exchange in the tenth, eleventh and twelfth counts of the First Amended Complaint.

IT IS ORDERED that as to said tenth, eleventh and twelfth counts judgment be, and the same is hereby, entered in favor of defendant New York Stock Exchange.

IT IS FURTHER ORDERED that all claims against defendant New York Stock Exchange as set forth in plaintiffs' First Amended Complaint be, and the same are hereby, dismissed with prejudice.

IT IS FURTHER ORDERED that defendant New York Stock Exchange shall be awarded costs.

Dated: April 6, 1976.

United States District Judge

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ATTORNEYS FOR Lance
DATE Aug. 13, 1976 3:20PM